United States Court of Appeals
for the Second Circuit

APPENDIX

77-6010/11

UNITED STATES COURT OF APPEALS
FILED
JAN 26 1977
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

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WITH PROOF
OF SERVICE

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

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BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs-Appellants,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS, INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTO CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs-Appellants,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

JOINT APPENDIX
(Volume I of II - Pages i - iii and A-1 - A-416)

CHARLES J. HECHT, ESQ.
Counsel for Plaintiffs-Appellants
British American Commodity Options Corp. and Lloyd, Carr & Co.
Suite 1760, 60 East 42nd Street, New York, New York 10017 - (212) 490-3252

Of Counsel
HAIG COSTIKYAN

GUSRAE, GREENE & KAPLAN
by DAVID GREENE
MARTIN KAPLAN

LEONARD GOLDSTEIN
GOLDSTEIN, AHALT & BENNETT
Counsel for other Plaintiffs-Appellants
College Park, Maryland

HOWARD SCHNEIDER, General Counsel
FREDERIC T. SPINDEL, Associate General Counsel
LESLIE BLAU, Special Counsel
Counsel for Defendants-Appellees
2033 K Street, N.W., Washington, D.C. 20581

(6038A)

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PLAINTIFFS

BRITISH AMERICAN COMMODITY
OPTIONS CORP. &
LLOYD , CARR & CO.

DEFENDANTS Knapp

BAGLEY,WILLIAM T. ,Chairma
Commodity Futures Trading
commission
RAINBOLT JOHN V. Vice Cha
of the Commodity Futures
trading commission
DUNN READ P.
SEEVERS, GARY &
MARTIN ROBERT L. , commiss
Commodity Trading Commiss

CAUSE

5 U.S.C.sec 706 , 7U.S.C. sec 3, 28 U.S.C. 1331 , and 28 U.S.C. sec 1337. declaratory judgment against defts and permenent injunction against def from implementing proposed regulations relateing to commodity options transactions published in Fed Reg Vol 41 # 197 .

jhb

ATTORNEYS

CHARLES H HECHT
60 East 42 Street
N.Y.C. 10017
(212) [illegible]

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civ 5124 BRITISH AMER. COMMODITY -v- BAGLEY ,Chairman Commodity Futures Co
KNAPP J.

DATE	NR.	PROCEEDINGS
1-16-76	1	Filed complaint and issued summons
1-17-76	2	Filed ORDER TO SHOW CAUSE re: pltffs application for a preliminary injunction and a T.R.O. . ret 11-19-76 in rm 307 at 2:00 . Knapp J.
1-23-76	3	Filed memo of law by pltff re: support of the motion for a TRO and or Preliminary Injunction.
1-29-76	4	Filed Amended complaint for a preliminary & permanent injunction.
12-02-76	5	Filed memo of law by pltff re: support of application for declaritory judgment,.
12-03-76	6	Filed motion by pltff re: an order temporarily restraining the defts etc. pending the determination of pltffs' application for preliminary injunction.
12-03-76	7	Filed afdvt by pltff re: support of the motion for declaritory judgment & a TRO.
12-03-76	8	Filed notice of motion by deft Commodity Futures Trading Comm. re: an order pursuant to Rule 56 FRCP granting deft summary judgment. ret. 12-10-76.
12-03-76	9	Filed memo by deft re: support of the motion for summary judgment,.
12-03-76	10	Filed certificate of William T Bagley re the donument attched.
12-03-76	11	Filed certificate of service of ddefts motion &memo for summayy judgment by mail on 12-03-76.
12-03-76	12	Filed affdvt of Peter Aaron by pltff re: support of the motion for a T.R.O.
12-07-76	13	Filed Memorandum Opinion & Order # 45421 the renewed motion for a T.R.O. is denied Knapp J. m/n
12-08-76	14	Filed corrected copy of defts' memo re: support of their motion for summary judgment,
12-08-76	15	Filed certificate of service of corrected copy of memo in support of summary judgment by Jay Grossman upon pltffs by Charles Hecht.
2-08-76	16	Filed pltffs memo re: support for decalritory judgemant etc.
2-10-76	17	Filed affdvt by pltff of John Forma re: support of pltffs application for declaritory relief.
2-10-76	18	Filed affdvt of John Carr by pltff re
2-23-76	19	Filed report ofthe advisory committee on definition & regulation dated 7/6/76.
2-23-76	20	Filed written submissions received by CRTC on options to purchase . etc.
12-22-76	21	Fld memo Opinon & order # 45457 pltff's motion for a Prelim. Inj is denied except as to the rules requiring segregation, the defts motion is denied with respect to said requirment of segregation & is otherwise granted. Settle order on notice . Knapp J.
1-6-77	22	Fld Order & Judgment deft's their agents etc are preliminarily enjoined from enforcing the segregation requirments(section32.6) against pltff , defts' motion for summary judgment is granted except as to said segregation requirments & there being no just reason for delay judgment to be entered in favor of deft on all issues except enforcment of sec 32.6. Knapp J . Judgment Entered 1-7-77. Clerk. m/n
1-10-77	23	Fld notice of motion by defts re: reconsideration of the Court's order of 1/4/77 ret : 1-12-77
1-10-77	24	Fld defts memo of law re: support of its motion for reconsideration
01-11-77	25	Fld pltff's memo re: opposition to deft's motion to reargue.

CONTINUED ON PAGE TWO

CIVIL DOCKET CONTINUATION SHEET

76 civ 5124

PLAINTIFF	DEFENDANT	
BRITISH AMER COMMODITY	WILLIAM BAGLEY et al	DOCKET NO. ____ PAGE 2 OF ___ PAG

DATE	NR.	PROCEEDINGS
1-12-77	26	Fld deft's memo re: opposition to pltffs motion for a stay pending appeal etc.
01-13-77	27	Fld Notice of Appeal to the U.S.C.A by pltff Nat'lAssoc. of Commodity Option Dealers from that part of the order of 1/3/77 granting deft's motion for summary jdgmt. . copy to all parties.
01-13-77	28	Fld Notice of Appeal tothe U.S.C.A by pltffs Brit. Amer. Commodity & Lloyd, Carr & Co. from the order of1/3/77 granting deft's motion for summary jdgmt. with respect to the regulations relating option transactions & with the segregation requirments. copy to all parties
01-13-77	29	Fld Notice of Appeal by defts to the U.S.C.A. from the order of 1/3/77 from that part of the order preliminarily enjoining defts from enforcing the segregation provisions of sec 32.6. copy to all parties
01-17-77	29	Fld letter of Leonard Goldstein dated 1/10/77 with attached copy of an unsigned oder.
01-17-77	30	Fld letter affdvt of Nat'l Assoc. of Commodity Option Dealers re: opposition to deft's motion reconsideration.
12-30-76	31	Fld pltff's motion for a stay pending appeal etc.
01-17-77		Fld memo-end on entry # 31 re: motion denied for the reasons stated in open Court. Knapp J. m/n

COMPLAINT

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION, JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

COMPLAINT FOR A PRELIMINARY AND PERMANENT INJUNCTION

Come now the plaintiffs by their attorney Charles J. Hecht, and for their first cause of action against the defendants allege as follows:

1. The individual defendants herein at all times since January 1, 1976 have been the Commissioners of the Commodity Futures Trading Commission.

2. Plaintiff British American Commodity Options Corp. is a corporation with its principal offices located at 80 Wall Street, New York, New York, which is exclusively engaged in the retail sale and purchase of commodity options through the International Commodities Clearing House Ltd. and the London Metals Exchange.

3. Plaintiff Lloyd, Carr & Co. is a sole proprietorship with its principal offices located at 84 State Street, Boston, Massachusetts, which is exclusively engaged in the retail sale and purchase of commodity options through the International

Commodities Clearing House Ltd. and the London Metals Exchange.

4. Jurisdiction is conferred upon this Court by reason of 5 U.S.C. §706, 7 U.S.C. §3, 28 U.S.C. §1331 and 28 U.S.C. §1337.

5. This proceeding is brought to temporarily restrain and to enjoin the defendants and their agents and employees from implementing and/or enforcing "proposed" regulations relating to commodity option transactions first published in the Federal Register on October 8, 1976, a substantial portion of which will automatically become effective on November 22, 1976 and a declaratory judgment as to the legality and constitutionality of a substantial portion of such "proposed" regulations. A copy of such "proposed" regulations are annexed hereto as Exhibit "A".

6. That these "proposed" regulations, in certain material respects, are totally inconsistent with any proposals published by the Commodity Futures Trading Commission (the "CFTC") prior to October 8, 1976.

7. That in accordance with terms and provisions of the "proposed" regulations the plaintiffs submitted their written comments and a copy of the detailed comments submitted on behalf of the plaintiff, British American Commodity Options Corp. is annexed hereto as Exhibit "B".

8. Based upon information and belief the CFTC received a number of other comments from companies similarly situated to the plaintiffs herein as well as other interested persons.

9. Based upon information and belief the CFTC failed to give any consideration to these comments and never intended to give any consideration to these comments and, thus, the

industry and the general public has not been given any opportunity to participate in the promulgation of these rules and regulations in contravention of 5 U.S.C. §553.

10. The "proposed" regulations are clearly anti-competitive and in direct contravention of 7 U.S.C. §19 which requires this agency in adopting any rule or regulation to endeavor to take the least anti-competitive means. Exhibit "B" attached hereto and made a part hereof sets forth how the segregation and disclosure requirements set forth in the "proposed" rules are clearly anti-competitive in violation of the Sherman Anti-Trust Act and other statutes and contrary to the public interest.

11. The "proposed" rules and regulations are also discriminatory as to existing retail dealers of London commodity options, all as more fully set forth in Exhibit "B".

12. The segregation and disclosure requirements of the "proposed" regulations are also beyond the scope of the authority of the CFTC as this agency is specifically prohibited from regulating rates of commission and under an affirmative duty to foster competition in the public interest. Reference is made to Exhibit "B" which is specifically incorporated herein.

13. The registration, disclosure, segregation and recordkeeping requirements of the "proposed" rules and regulations are clearly arbitrary, capricious and an abuse of discretion, all as more fully set forth in Exhibit "B" annexed hereto and made a part hereof.

WHEREFORE, the plaintiffs request the following relief from the Court:

(a) Declaring that the "proposed" rules and regulations relating to commodity option transactions are being implemented without observance of the procedural requirements of the Administrative Procedures Act.

(b) Declaring that the "proposed" rules and regulations relating to commodity option transactions are anti-competitive and in direct contravention of 7 U.S.C. §19.

(c) Declaring that the "proposed" rules and regulations relating to commodity option transactions are discriminatory as to companies presently engaged in the retail sale of London commodity options.

(d) Declaring that the "proposed" rules and regulations relating to commodity option transactions are beyond the scope of authority of the Commodity Futures Trading Commission.

(e) Declaring that the "proposed" rules and regulations relating to commodity option transactions are arbitrary, capricious and an abuse of discretion.

(f) That the court issue a preliminary injunction preventing and restraining the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them from implementing or enforcing the "proposed" rules and regulations relating to commodity option transactions published in the Federal Register on October 8, 1976 during the pendency of this action.

(g) That this court issue a permanent injunction preventing and restraining the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing the "proposed" rules and regulations relating to commodity option transactions published in the Federal Register on October 8, 1976.

(h) That the plaintiffs be given all such other, further, and different relief as this Court may deem just and proper.

Dated: New York, New York

November 15, 1976

/s/

Charles J. Hecht, Esq.
Attorney for Plaintiffs
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232)

EXHIBIT "A" TO COMPLAINT

this in § 180.3(c)(3) and in the cautionary language required by § 180.3(c)(4); however, a new introductory sentence to § 180.3(c)(3) has been adopted to eliminate any confusion about the effect of the rule in this regard.

AMENDMENTS TO § 180.3(c) AND (d)

Paragraphs (c) and (d) are the same as previously proposed §§ 180.3(c) and (d), respectively. In this connection, it should be noted, however, that the Commission is amending the terms "claim or grievance" used in these paragraphs and defined in § 180.1(a). See 41 FR 42942, September 29, 1976. The amendment deletes the phrase "which is the forum for the settlement procedure" in the first sentence of that section. That phrase was inadvertently carried over from an earlier draft of the proposed rule. It creates a possibly confusing ambiguity and, accordingly, has been deleted. The amendment does not affect any substantive rights under paragraphs (c) and (d).

Rule § 180.3 will become effective November 29, 1976. Since it would be in the public interest for all the Commission's rules governing contract market arbitration and other dispute settlement procedures to become effective on the same date, the Commission has decided to delay the effective date of rules §§ 180.1, 180.2, 180.4, 180.5 and 180.6 as well.

In consideration of the foregoing, the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations by adding a new § 180.3 to Part 180, as follows:

* * *

[Text at ¶ 3323. CCH.]

* * *

Although these rules become effective November 29, 1976, the Commission encourages interested persons to submit written comments or suggestions on the rules. Materials submitted will be evaluated and considered with a view to amendment in appropriate cases. Comments should be directed to the Commodity Futures Trading Commission, 2033 K Street, N. W., Washington, D. C. 20581, Attn: Secretariat.

(Sections 5a(11) and 8a of the Commodity Exchange Act as amended ("Act"), 7 U. S. C. §§ 7a(11), 12a (Supp. IV, 1974).)

Issued in Washington, D. C. on September 24, 1976.

By the Commission.

PART 180—ARBITRATION OR OTHER DISPUTE SETTLEMENT PROCEDURES

Extension of Time

The Commodity Futures Trading Commission has decided to postpone until November 29, 1976, the effective date of §§ 180.1, 180.2, 180.4, 180.5 and 180.6 of its rules governing contract market arbitration and other dispute settlement procedures, which were adopted by the Commission on June 25, 1976. See 41 FR 27520 (July 2, 1976). These rules originally were to become effective on September 30, 1976. However, § 180.3 of the Commission's rules governing certain aspects of contract market arbitration and other dispute settlement procedures is to become effective in sixty days. See 41 FR 42942, September 29, 1976.

The Commission believes it would be in the public interest for all of its rules governing contract market arbitration and other dispute settlement procedures to become effective on the same date. For that reason, the Commission has decided to delay the effective date of §§ 180.1, 180.2, 180.4, 180.5 and 180.6 to November 29, 1976.

(Sections 5a(11) and 8a of the Commodity Exchange Act, as amended, 7 U. S. C. §§ 7a(11), 12a (Supp. IV, 1974).)

Issued in Washington, D. C. on September 24, 1976.

By the Commission.

[¶ 20,217] Proposed Regulation of Commodity Option Transactions.

Commodity Futures Trading Commission. October 8, 1976. (41 F. R. 44560). Notice in full text.

Commodity Option Transactions—Permitted and Regulated by CFTC—Interim Regulations Proposed.—The first of two stages in the process of permitting and regulating commodity option transactions has been announced by the Commodity Futures Trading Commission in the form of proposed interim regulations. The proposed Part 32 would become effective 45 days after publication of its adoption and would remain in effect after the second stage regulatory scheme is adopted, with modifications. These interim regulations will regulate options transactions that are not specifically prohibited by statute (Sec. 4c(a)(B) of the Commodity Exchange Act—see ¶ 12,750).

Dealers in options will be required to register as futures commission merchants, and those associated with such dealers must register as associated persons. Customer funds will have to be segregated and information with respect to attendant fees will be required to be disclosed to customers. Reg. § 1.19, which forbids futures commission merchants from assuming financial responsibility for options transactions, will not be repealed by these interim rules, but the Commission will consider the repeal of Reg. § 1.19 when it considers the second stage of regulation. This second stage is tentatively scheduled for adoption 90 days after the publication of this notice. A major feature of this later stage will be a three year pilot program of contract market trading in options. Transactions off contract markets in commodity options are scheduled to be banned by the second stage regulatory scheme. CFTC proposals for such "dealer options" have been withdrawn.

See ¶ 12,750 and 12,825, "Liabilities—Prohibitions" division.

The Commodity Futures Trading Commission ("Commission") is considering adoption regulations under the Commodity Exchange Act, as amended ("Act"), 7 U. S. C. § 1 et seq., relating to commodity options. The regulations are to be adopted in two stages. The first stage involves adoption of the interim regulations that accompany this notice as a new Part 32 of the Commission's regulations. The interim regulations are to become effective 45 days from the date of publication of this notice (November 22, 1976), and will remain in effect thereafter, except to the extent amended by the second stage of the regulations. However, as indicated below, the Commission encourages comments on the proposed interim regulations in order to determine whether they should be modified prior to their adoption. The Commission anticipates the second stage of regulations will become effective in approximately 90 days.[1]

Under the two-stage procedure, the Commission plans to adopt comprehensive regulations for a limited, rigidly-controlled three-year (or shorter) test program that ultimately will require commodity options to be purchased and sold on or through the facilities of Commission-designated boards of trade in the United States or Commission-recognized foreign commodities exchange systems which satisfy stringent self-regulation requirements. The test program will be designed to determine the nature and extent of the impact of commodity option trading on the underlying futures and cash markets, the economic utility of commodity option trading and the capability of the exchanges to conduct adequate market surveillance and to assure orderly markets. The Commission believes that the test program will enable the Commission to obtain sufficient data on which to base a permanent regulatory program concerning commodity options or, if necessary, to determine to prohibit trading in commodity options in the United States. The details of the test program will be provided at the time that the second stage of the regulations is proposed.

The principal authority of the Commission to regulate commodity option transactions is contained in Section 4c of the Act.[2] Section 4c(a)(B) of the Act prohibits the offer and sale of certain commodity options—generally those relating to agricultural commodities.[3] Under Section 4c(b)

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[1] The basic thrust of the Commission's proposals and the time within which they are to be implemented were announced at a public meeting of the Commission held in Washington, D. C. on September 13, 1976.

[2] 7 U. S. C. § 6c (Supp. IV, 1974). The Commission also has general rule-making authority under section 8a of the Act, 7 U. S. C. § 12a (Supp. IV, 1974). The Commission points out also that Section 2(a)(1) of the Act, 7 U. S. C. § 2 (Supp. IV, 1974), provides that the Commission shall have "exclusive jurisdiction" with respect to "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery . . . ." The interim rules announced today are effectuated pursuant to this authority as well as that contained in Sections 4c and 8a of the Act.

[3] 7 U. S. C. § 6c(a)(B) (Supp. IV, 1974). So that all regulations concerning commodity options will be in one place, for convenience, the Commission has incorporated the prohibition contained in Section 4c(a)(B) as section 32.2 (a) of the proposed interim regulations. Section 4c(a)(B) expressly forbids option transactions relating to those commodities which were regulated under the Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974 (Pub. Law No. 93-463, October 23, 1974), thereby continuing the Act's prohibition with respect to those commodities. Those previously-regulated commodities were: ". . . wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, but-

(Continued on the next page.)

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of the Act, however, it is unlawful to offer or sell an option involving any other commodity regulated under the Act contrary to such rules and regulations as the Commission may prescribe.[4] Section 4(c) provides in pertinent part as follows:

> No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under [the Act], but not specifically set forth in section 2(a) of [the Act] prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe . . . .[5]

Thus, the Commission is empowered, under Section 4c(b), to determine if and under what circumstances commodity option trading will be permitted. For example, the Commission could (a) prohibit all commodity option trading, (b) permit all commodity option trading "under such terms and conditions as the Commission shall prescribe," or (c) permit some forms of trading, subject to Commission rules and regulations, and prohibit others.

Prior Proposals

On October 22, 1975, the Commission announced that it was considering the adoption of rules to regulate—or perhaps forbid—transactions in commodity options, including the promulgation of a temporary rule pending the adoption of a definitive regulatory program. See 40 Fed. Reg. 49360 (October 22, 1975).[6]

On February 20, 1976, the Commission proposed comprehensive regulations governing off-exchange commodity option transactions, including the so-called "dealer options". See 41 Fed. Reg. 7774 (February 20, 1976). The Commission has determined that, by the time of implementation of its second stage of regulations, only designated boards of trade and recognized foreign commodities exchange systems offering commodity options will be permitted, thereby, in effect, banning dealer options. Thus, the Commission has determined not to adopt the previously proposed regulations.[7]

In its release on the proposed regulations, the Commission invited interested persons to submit comments and to participate in oral hearings which were held in Washington, D. C., on March 8, 1976. The Commission also noted in its release that it was considering delaying the adoption of comprehensive regulations until it has an opportunity to study the recommendations of its Advisory Committee on the Definition and Regulation of Market Instruments. That Advisory Committee was assigned the re-

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(Footnote 3 continued.)
ter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice . . . ." Section 2(a)(1) of the Act.

[4] Section 4c(b) governs options involving the newly-regulated commodities, namely "all other goods and articles [except onions] . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in . . . ." Section 2(a)(1) of the Act.

[5] 7 U. S. C. § 6c(b) (Supp. IV, 1974). Section 4c(b) also provides that, if possible, rules were to be adopted within one year after the effective date of the section. However, the Commission advised Congress, in accordance with the provisions of Section 4c(b), that it would be unable to meet the one-year time period ending April 21, 1976, within which to have comprehensive commodity option regulations in effect and that additional time would be required to carry out the Congressional mandate contained in Section 4c(b). See 41 Fed. Reg. 16685 (April 21, 1976).

[6] Previously, on June 24, 1975, the Commission had adopted a broad antifraud rule applicable to commodity option transactions. See 40 Fed. Reg. 26505 (June 24, 1975). That rule, 17 C. F. R. § 30.01, will be redesignated as § 32.9 of the proposed interim regulations.

[7] Those proposed rules basically would have made it unlawful for any commodity option dealer, as defined in the rules, to offer to enter into, enter into or confirm the execution of any transaction subject to the proposed rules unless the dealer met certain financial requirements and registered with the Commission as a commodity option dealer. Registration as a commodity option dealer would have entailed the filing of detailed information in the form of an application. Both financial data and information about business practices were required. Also, the proposed rules required a dealer, in connection with offers to enter into commodity option transactions, to inform each prospective purchaser that the dealer had filed an application in connection with its registration with the Commission containing information about the dealer, the dealer's business and its financial condition and that copies of such filings were available for public inspection at all offices of the dealer and at the Commission's offices in Washington, D. C.

sponsibility, among other things, to submit a report and recommendations to the Commission on appropriate regulations or restrictions concerning commodity options.[8] At the time of its proposal concerning off-exchange commodity option transactions, the Commission stated:

> [A]lthough the proposed regulations relate to transactions which are not entered into on a contract market, the Commission is affirmatively considering permitting commodity option transaction to be traded on or subject to the rules of a contract market which have been approved by the Commission as adequate to effectuate the purposes of the Act. . . . Ultimately the Commission may adopt regulations which restrict commodity option transactions to trading on contract markets.[9]

The Commission, after carefully considering the comments received on its prior proposals, the presentations made at its oral hearing, and the report and recommendations of its Advisory Committee, has determined in large measure to do just that—to implement a test program for commodity option transactions, the effect of which will be to restrict commodity option transactions, other than certain specified "trade option" transactions, to domestic boards of trade or foreign commodities exchange systems designated or recognized by the Commission. As explained in more detail below, the proposed interim regulations have been primarily designed to provide adequate customer protections in the offer and sale of commodity options. However, in order to avoid any undue hardships on affected persons, the implementation of this regulatory program will be phased in gradually so that commodity option transactions lawfully entered into prior to the effective date of the proposed interim regulations will not be affected, and, during the period in which only the interim regulations are in effect, commodity option transactions will be permitted to be entered into in accordance with the terms of the interim regulations. Nevertheless, the Commission wishes to emphasize that, when the second stage of the Commission's regulations becomes effective, it will no longer be permissible to offer or to sell commodity options or to enter into commodity option transactions in the United States except in accordance with those regulations, *i.e.*, *only* on or through designated domestic boards of trade or recognized foreign commodities exchange systems.

At the outset the Commission wishes to stress certain points concerning the proposed interim regulations and how they will interact with the second stage regulations which the Commission will shortly propose:

(1) Section 32.2(b) of the proposed interim regulations provides that commodity option transactions involving commodity futures contracts traded on or subject to the rules of Commission-designated contract markets or involving the prices of such contracts are prohibited except under such terms and conditions as the Commission shall prescribe. The Commission believes that, under the Act, particularly Sections 4c(a)(C) and 4h, it is unlawful to trade options involving domestically traded futures contracts or the prices of such contracts otherwise than by or through a member of a contract market and subject to the rules thereof. However, since the Commission has been advised that such commodity option transactions are being offered and entered into in the United States, in order to avoid any question with respect to this issue, the Commission has decided to set forth an express codification of the Commission's view in proposed section 32.2(b). The Commission recognizes that the effect of proposed section 32.2(b) would also be to prohibit commodity option transactions effected even on or subject to the rules of contract markets, since the Commission has not yet prescribed the terms and conditions under which such trading will be permitted. Such terms and conditions will be the subject of the second stage of regulations to be proposed by the Commission. Trading in commodity options involving domestically traded futures contracts on any contract market will not be permitted until there are comprehensive regulations in effect and the contract market has complied with such regulations. Thus, the Commission's proposed interim regulations prohibit all commodity option transactions involving domestically traded futures contracts or prices of such contracts, including those traded on or subject to the rules of a contract market.

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[8] See 40 Fed. Reg. 32866 (August 5, 1975). The Advisory Committee's report, which was transmitted to the Commission on July 6, 1976, is published as a special supplement numbered 26 to the CCH COMMODITY FUTURES LAW REPORTER (July 15, 1976).

[9] 41 Fed. Reg. 7774 (February 20, 1976).

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(2) The interim regulations are designed to regulate those commodity option transactions which are not otherwise prohibited (*i.e.*, not otherwise set forth in proposed section 32.2). At the present time, the Commission is aware that so-called "London options"[10] are being offered in the United States, as well as the so-called "dealer options" on physical commodities. Briefly, the interim regulations will have the following effect on these types of commodity option transactions:

(A) Under proposed section 32.3(a), on and after January 17, 1977 (approximately 105 days from the date of publication of this notice), it will be unlawful for any person to accept funds or other property from an option customer as payment of the purchase price of a commodity option unless the person is registered as a futures commission merchant under the Act. Until such time, of course, persons may continue to accept funds or other property without being so registered.

(B) Under proposed section 32.3(b), on and after January 17, 1977, it will be unlawful for a person to solicit or accept orders for commodity options or for an individual to be associated with any such person, unless registered as a futures commission merchant or an associated person of such futures commission merchant, respectively, under the Act.

The Commission wishes to emphasize that the Commission fully intends to implement these regulations and that the registration process [See (A) and (B) above] takes time. Therefore, as explained in more detail below, the Commission suggests that affected persons file their registration applications as soon as possible and not defer filing until the effective date of the regulations.

The Commission points out that, upon adoption of proposed sections 32.3(a) and (b), writers of commodity options or other persons assuming financial responsibility for commodity options may offer or sell commodity options in the United States only through registered futures commission merchants and their registered associated persons. In this connection, the Commission wishes to advise affected persons that regulation § 1.19—which prohibits a futures commission merchant from issuing or otherwise assuming financial responsibility for a commodity option transaction—will not be repealed by the proposed interim regulations.[11] Consequently, it will continue to be unlawful for a futures commisison merchant to assume financial responsibility, whether by contract or by operation of law, for a commodity option transaction. The Commission will consider the repeal of § 1.19 in connection with the proposed second stage of its regulations. If repealed, futures commission merchants would then be permitted to issue or otherwise assume financial responsibility for commodity option transactions in accordance with the terms of those regulations.

(C) Immediately upon the effective date of the interim regulations, under proposed section 32.6 any person which receives funds or property from an option customer as payment of the purchase price for a commodity option must segregate from its assets, and treat as belonging to the option customer, *all* such funds and property received, including any amounts characterized as sales commissions or similar fees. The funds and property must be segregated (i) in the United States and (ii) until the option expires or, if the customer exercises the option, until the customer's rights under the option have been satisfied. As noted above, on and after January 17, 1977, only registered futures commission merchants may receive funds or property from option customers in connection with a commodity option transaction. Thus, writers and other persons who assume financial responsibility for commodity options may receive such funds and property from an option customer only until January 17, 1977, but must segregate and treat those assets as provided in proposed section 32.6. After January 17, 1977, such persons may not receive the funds or property except from a futures commission merchant which accepted them from the option customer and then only after the segregation requirements have been satisfied by the futures commission merchant. The Commission is aware that proposed section 32.6 may, in certain cases, require "double segregation." For example, in the case of the sale of London options, a person receiving the funds from an option customer in the United States as payment for the option may not remit those funds to London in order to obtain or maintain the option position with a London broker. The Commission believes that the proposed segregation requirements are an essential customer protection to be afforded commodity option customers in the United States. The Commission recognizes, however, that its proposed segregation requirements may impose a financial hardship on some affected persons, and as noted in more detail below, requests specific comments on these requirements, particularly alternatives which could provide substantially equivalent customer protections.

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[10] London commodity exchange options cleared through the International Commodities Clearing House and commodity options written by or through the individual members of the London Metals Exchange.

[11] Because the repeal of § 1.19 would necessitate substantial revisions of regulation § 1.17 (in order to assure the financial responsibility of futures commission merchants), the Commission did not feel that these revisions could be made without additional study and therefore determined not to propose the repeal of § 1.19 as part of the proposed interim regulations. See 17 C. F. R. §§ 1.17 and 1.19.

(D) Upon the effective date of the proposed interim regulations, § 1.17 of the regulations will be amended to provide that a futures commission merchant engaged in commodity option transactions must have an adjusted working capital which at a minimum equals $50,000. As indicated above, the Commission anticipates that when the second stage of its regulations becomes effective, there will be additional, substantial amendments to § 1.17 in order to assure the financial responsibility of futures commission merchants engaged in commodity option transactions.

(E) Under proposed section 32.5, upon the effective date of the interim regulations, persons soliciting or accepting orders for commodity option transactions must make summary disclosure to option customers, prior to the entry into the commodity option transaction, of various aspects of the transaction, including information regarding all fees and charges to be paid by the option customer in the transaction, such as premiums, mark-ups on premiums, and sales commissions. The Commission anticipates that the second stage of its regulations regarding commodity options will impose additional, more detailed, disclosure requirements on such persons.

A section-by-section explanation and the text of the Commission's interim regulations are set forth below:

Definitions

Section 32.1 of the proposed rules defines certain terms used in the rules. For convenience, the terms "commodity option transaction" and "commodity option" are each defined in section 32.1(a) to mean any such transaction or agreement in interstate commerce which the Commission is authorized to regulate under Sections 2(a)(1) and 4c(b) of the Act.[12] Section 32.1(b) defines "interstate commerce" to have the same meaning as set forth in Sections 2(a) and 2(b) of the Act.[13] Section 32.1(c) defines "option customer" as any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option,[14] but does not include a person required to register as a futures commission merchant in accordance with the proposed rules. Futures commission merchants were excluded from the definition of "option customer" to avoid the implication that futures commission merchants are "option customers" of their principals—who may be option writers—when acting in an agency capacity in commodity option transactions. If the definition of option customer were construed to include futures commission merchants, then in accordance with the provisions of proposed section 32.3(a),[15] a writer of an option, for example, who markets such options through a futures commission merchant, would technically be required to register as a futures commission merchant at the time he received from an option customer —the futures commission merchant—either money, securities or property as payment of the purchase price in connection with the commodity option transaction. As a result of the retention of § 1.19 of the regulations, the Commission does not intend that option writers be required to register as futures commission merchants under the interim regulations. Accordingly, it has excluded futures commission merchants from the definition of option customer.

Proposed section 32.1(d) defines "purchase price" to mean the total actual cost paid or to be paid, directly or indirectly, by an option customer for entering into and maintaining an interest in a commodity option transaction, by whatever name called. Subsumed within the definition of purchase price are the premium,

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[12] See text accompanying notes 2, 3 and 4 *supra*.

[13] 7 U. S. C. §§ 2, 4 (Supp. IV, 1974).

[14] As set forth in section 32.1(a), the terms commodity option and commodity option transaction are used interchangeably in the proposed rules.

[15] The provisions of this section are explained in more detail below.

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mark-ups on the premium, as well as the costs, fees, and other charges comprising the purchase price. Proposed section 32.1(e) defines "striking price" to mean the price at which an option customer may purchase or sell the commodity or the contract of sale of a commodity for future delivery which is the subject of a commodity option transaction.

Prohibited Transactions

As indicated above, in order to have commodity option requirements self-contained in one set of regulations, proposed section 32.2(a) of the interim regulations incorporates the existing statutory prohibition on the offer or sale of commodity options involving previously regulated commodities. And, as previously explained, proposed section 32.2(b) expressly prohibits the offer or sale of commodity options involving domestically traded futures contracts.

Unlawful Commodity Option Transactions

Proposed section 32.3(a) provides that on and after January 17, 1977, it shall be unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as a futures commission merchant under the Act.[16] Proposed section 32.3(b) provides that on and after January 17, 1977, it shall be unlawful for any person to solicit or accept orders (other than in a clerical capacity) for the purchase or sale of any commodity option, or to supervise any person or persons so engaged, unless such person is (1) registered as a futures commission merchant under the Act, or (2) if such person is an individual, registered as an associated person of a specified futures commission merchant under the Act. In addition, it shall be unlawful for any futures commission merchant to permit an individual to become or remain associated with such futures commission merchant in specifically enumerated capacities if such futures commission merchant knew or should have known that such individual was not registered as an associated person.

The Commission wishes to stress that the registration requirements apply to all persons who accept orders for commodity options, irrespective of whether the order is accepted directly from an option customer. Thus, if a futures commission merchant utilizes the services of another firm in order to arrange for the execution of the order of an options customer, the other firm is also required to register as a futures commission merchant.

The Commission realizes that the term futures commission merchant in Section 2(a)(1) of the Act is not defined to include persons engaged in commodity option activities, and it is not intended to require that persons registering as futures commission merchants in accordance with the provisions of the interim regulations be required to solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of a contract market. Rather, the Commission has determined, pursuant to its plenary power to regulate commodity option transactions in Sections 2(a)(1) and 4c(b) of the Act, to entrust option activities *only* to futures commission merchants and associated persons of specified futures commission merchants, inasmuch as these are categories of registrants with which the Commission and the public are already familiar This will allow the Commission to regulate commodity option activities in a less complicated fashion. For example, the proposed interim regulations would automatically pick up the standards for registration and denial of registration contained in the Act and the Commission's interpretation thereof; they would automatically make applicable the reparation procedures under the Act; and they would allow for the incorporation of financial standards and related requirements in the context of revisions to § 1.17 of the regulations.

The Commission is also mindful of the fact that it proposes to exclude associations, partnerships, corporations, trusts and any other entities from the category of persons who may register as associated persons in order to comply with the provisions of section 32.3(b). The Commission believes that entities engaged in soliciting or accepting orders for the purchase or sale of commodity options should be registered as futures commission merchants, and that the associated person category of registrant in the commodity options area should be limited to individuals employed by such entities, irrespective of whether they may presently be classified as associated persons or agents of futures commission merchants under Section 4k of the Act, 7 U.S.C. § 6k (Supp. IV, 1974).

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[16] The Commission proposes to amend § 1.3(p) of its regulations, 17 C. F. R. § 1.3(p), defining the term "futures commission merchant", to add a new subsection (2) which would include within the definition of the term "futures commission merchant", any person required to register as a futures commission merchant by virtue of the interim regulations.

It should be noted that the anticipated effective date of these rules is November 22, 1976. The registration provisions, however, do not go into effect until 60 days thereafter. This is to allow persons sufficient time to submit, and for the Commission to process, applications for registration. Processing of applications normally take approximately 60 days. Therefore, as indicated above, the Commission urges persons wishing to register as futures commission merchants or associated persons to submit their applications promptly. A person who defers filing an application until the effective date of the regulations runs the risk that the application may not be processed on a timely basis; a person who does not file an application until after the effective date increases the risk that the application will not be processed by the time the registration requirements go into effect. The Commission intends to expedite the processing of such applications, and a prompt filing will enable the Commission to do so on a timely basis.

Section 32.3(c) provides that persons required to register as futures commission merchants or as associated persons in accordance with sections 32.3(a) and (b), which furnish the services specified in that portion of Section 2(a)(1) of the Act defining the term "commodity trading advisor", shall not be included in the term "commodity trading advisor", if, at the time such services are furnished, such person is registered as a futures commission merchant or as an associated person under the Act and the furnishing of such services is solely incidental to the conduct of such person's activities requiring such registration. The Commission has previously expressed the view that generally persons who are offering commodity options to the public should register with the Commission as commodity trading advisors.[17] In CFTC Staff Interpretative Letters Numbered 76-13 and 76-13a,[18] the Commission's Office of General Counsel stated that the Commission's view applied to futures commission merchants. In view of the fact that persons soliciting or accepting orders for commodity options are to be required to register either as futures commission merchants or associated persons under the proposed interim regulations, the Commission has determined that, once such persons are in fact registered, the registration of such persons as commodity trading advisors would serve no additional public interest. Accordingly, while the Commission believes that the staff interpretation is a correct interpretation of existing law, compliance with that interpretation will not be necessary upon the adoption of the interim regulations, and, pending such adoption, the Commission has determined that it will not take any enforcement action against any futures commission merchant, based solely on its failure to register as a commodity trading advisor in compliance with such interpretation from and after the date of the publication of this notice.

Those persons which are already registered as futures commission merchants or associated persons under the Act, and which would be required to register as such by virtue of these proposed rules, need not re-register in those categories, but should immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under these proposed rules. This provision is set forth in proposed section 32.3(d).

Exemptions

The Commission previously indicated that no public interest would be served by regulatory provisions governing commercial commodity option transactions with certain users, producers or consumers, and previously proposed a "trade option" exemption for such persons.[19] The Commission has again considered this issue in light of the comments received on its prior proposal, as well as the recommendations from its Advisory Committee on Market Instruments, and has concluded that there is no substantial public interest to be served by requiring the registration of certain producers, processors, commercial users, or merchants, who engage exclusively in commercial-type transactions. The Commission believes that its antifraud rule gov-

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[17] See 40 Fed. Reg. 49361, n. 11 (October 22, 1975).

[18] CCH COMMODITY FUTURES L. REP. ¶ 20,174 (Interpretative letter 76-13a has not yet been published in this service).
[See ¶ 20,206. CCH.]

[19] See 41 Fed. Reg. 7776 (February 20, 1976).

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erning commodity option transactions achieves the full regulatory objective in such cases. Accordingly, except for the provision of its antifraud rule (section 32.9) and otherwise prohibited transactions (section 32.2), the Commission has determined to exempt from the operation of these rules the offer of commodity option transactions by a person who has a reasonable basis to believe that the option is being offered to a purchaser referred to in proposed section 32.4(a) and that the purchaser is being offered or acquires such option for purposes related to its business. Of course, to the extent that a person offers or sells commodity option transactions to persons other than, or in addition to such purchasers, compliance with these rules would be required.

The Commission intends to monitor the effect the trade option exemption contained in section 32.4(a) has in the marketplace to ascertain whether it is necessary or appropriate. The Commission wishes to reemphasize that the exemptive provisions expressly do not exclude any person from the proscriptions in the Commission's general antifraud rule governing commodity option transactions presently in effect, which is to be redesignated as section 32.9 of the proposed rules. The existing antifraud rule applies, and will continue to apply, to all offers and sales of commodity option transactions subject to Commission regulation whether or not these transactions are subject to or exempt from the provisions of any of the Commission's rules affecting commodity options.

Additionally, proposed section 32.4(b) provides that the Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of these rules, other than those of sections 32.2 (prohibited transactions), 32.8 (unlawful transactions) and 32.9 (antifraud rule), if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption. At the present time, the Commission contemplates no additional exemptions but has inserted this provision in the proposed regulations to permit maximum Commission flexibility. Since the ultimate purpose of the Commission's regulations will be to implement a rigidly controlled option test program, exemptions would be considered only in the most extraordinary of circumstances.

Disclosure

Proposed section 32.5 sets forth the disclosure which a person soliciting a commodity option transaction must provide to an option customer not less than 24 hours prior to the entry into the commodity option transaction. Commodity option customers are required to be provided with a summary disclosure statement setting forth (1) the actual amount of the purchase price and the method by which the premium is established, including a separate listing of the premium, mark-ups on the premium, costs, fees and other charges comprising the purchase price; (2) a statement of (i) the services to be provided for the separate elements comprising the purchase price, (ii) the striking price and the method by which the striking price is established, (iii) the total quantity or quality of the commodity which may be purchased or sold upon exercise of the commodity option or which underlies the contract of sale for future delivery which may be purchased or sold upon exercise of the commodity option, and (iv) any and all additional costs which may be incurred by the option customer if the option is exercised, including storage costs, interest charges, commissions (whether denominated as sales commissions or otherwise), and all similar fees and charges; (3) the price level that the underlying commodity or the underlying contract of sale for future delivery must reach during the life of the option for the option customer to realize a profit in the commodity option transaction, together with an explanation of the effect of applicable foreign currency fluctuations; (4) a bold-faced statement on the first page of the disclosure statement setting forth certain, specific cautions regarding commodity option transactions; and (6) a statement of certain risks to be considered by the customer before entering into the commodity option transaction. The Commission wishes to emphasize that this disclosure should be clear, intelligible and understandable to any person reading it. This disclosure statement is required to be furnished to option customers in advance of purchase so as to familiarize them with certain aspects of the option transaction. The Commission is aware that a significant number of commodity option transactions currently are being offered and sold through the use of high-pressure sales tactics to persons who are relatively unfamiliar with the commodities markets generally, and with commodity options in particular. The Commission is also aware that at the present time even when disclosure is made to option customers, it is often inaccurate or misleading, either in content, presentation, or both. Given the interim nature of the proposed rules, the disclosure statement required to be furnished by section 32.5 is by no means intended to convey the impression that the items contained therein are the only things which need be disclosed to prospective customers, and the Commission would encourage persons soliciting prospective option customers to provide them with sufficient information to evaluate the transaction more fully and the futures commission merchant and/or associated person through whom such customers are dealing, as well as their financial condition. In this connection, as noted above, when the Commission proposes the second stage of its regulations, it expects to require additional, more detailed information to be disclosed to prospective option customers.

The Commission understands that if an option customer purchases an option on a contract of sale of a commodity for future delivery which is traded on a foreign commodity exchange, the solicitor of such option would not always be able to provide the option customer with certain "price" information until the trade is executed. In that event proposed section 32.5(b) provides that to the extent the actual price information called for by paragraphs (1), (2) and (3) of section 32.5(a) is not known at the time the disclosure statement is to be delivered to the prospective option customer, a good faith estimate of such information should be provided as part of the disclosure statement, and upon execution of the commodity option transaction for the option customer, the person required to deliver the disclosure statement shall immediately provide all actual price information in writing to the option customer.

Segregation

The Commission has provided in proposed section 32.6 that any person which accepts money, securities or property from an option customer as payment of the purchase price in connection with a commodity option transaction shall segregate such money, securities and property in the United States and shall treat and deal with such assets as belonging to such option customer until expiration of the term of the option or, if the option customer exercises the option, until all rights of the option customer under the commodity option have been fulfilled. The Commission wishes to emphasize that section 32.6 requires that assets must be segregated *in the United States*, so that such assets will not be subject to the attachment or other laws or requirements of any other nation. The Commission views these requirements as essential to protect at least the basic investment of commodity option customers as well as to assure, to the extent feasible, the financial integrity of option transactions. In the Commission's view, these segregation requirements are a cardinal tenet of commodities regulation, and will help to prevent fraud. Absent segregation, these assets could be used by a person in its general operations. In addition, absent segregation, these assets might be subject to the claims of general creditors of the person accepting them. As noted above, the Commission is aware that the segregation requirements could result in "double segregation," particularly where futures commission merchants or other persons are engaged in the offer and sale of London options. The Commission is further cognizant of the fact that this segregation requirement may impose a financial strain upon the vast percentage of persons presently engaged in the offer and sale of commodity options. Accordingly, the Commission encourages interested persons, particularly those engaged in the offer and sale of London commodity options, to submit comments on the Commission's segregation proposals and to suggest alterations which will provide adequate customer protections. In submitting any alterations, commentators should be aware that, in the Commission's view, what is of paramount importance in its fundamental customer protection aspects. In submitting any alternative proposals, commentators should be aware that, in the Commission's view, what is of paramount importance is that option customers be assured, at the very least, that the assets which they put up to purchase the option will be safe during the term of the option and be available to be refunded to option customers in the event that an option customer exercises the option but is unable to obtain satisfaction of the obligations owing to him because of the insolvency of the futures commission merchant or its principals.

The provisions of section 32.6 are patterned essentially after the requirements

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for segregation of customer funds in Section 4d(2) of the Act and regulation §§ 1.20 (a) (customers' money, securities, and property to be segregated and separately accounted for), 1.25 (investment of customers' funds), 1.26(a) (deposit of obligations purchased with customers' funds), 1.27(a) (record of investments), 1.28 (appraisal of obligations purchased with customers' funds), 1.29 (increment or interest resulting from investment of customers' funds), and 1.32 (segregated accounts; daily computation and records).[30]

The Commission had originally intended to permit futures commission merchants to exclude sales commissions from the assets required to be segregated. Because of the difficulty of defining "premium" and "commissions", this might have permitted unscrupulous persons to characterize the major portion of the purchase price as a "sales commission" and thereby tend to encourage attempts to evade the segregation requirements. The alternative would have been to impose a maximum percentage on the amount of permissible sales commissions, but the Commission believes that it should not engage in this practice. Accordingly, the Commission has decided that it is in the public interest that futures commission merchants segregate *all* assets received from customers as payment of the purchase price in connection with a commodity option transaction and treat such assets as belonging to option customers. The Commission specifically requests comments on whether it should permit some portion of the purchase price not to be segregated, and if so, how that portion could be determined.

The Commission is further aware that its segregation requirements may have to be modified in its second stage regulations to take into account option trading on boards of trade designated by the Commission and on recognized foreign commodities exchange systems.

Books and Recordkeeping

Proposed sections 32.7(a) and (b) require persons receiving the purchase price for a commodity option from an option customer to maintain full, complete and systematic records of all such transactions. Among other things, such persons are required to keep: all orders, signature cards, books of record, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements required by proposed section 32.5, solicitation or advertising material, and all other literature or written advice distributed to option customers or prospective option customers; the true name and address of each commodity option customer or prospective commodity option customer solicited; and the true name and address of each maker, underwriter, issuer or other person who assumes or purports to assume any financial responsibility for the fulfillment of any commodity option transaction engaged in by such person. Under proposed section 32.7(c), persons accepting orders from persons other than an option customer (for example, a corresponding futures commission merchant of a futures commission merchant dealing directly with an option customer) must keep similar records to the extent necessary to reflect their participation in the transactions.

In addition, under proposed section 32.7(d) each person which accepts an order for a commodity option, whether from an option customer or any other person, must prepare a written record of that order, including an account identification and order number and must record the date and time the order is accepted, is transmitted for execution, and, if the order is executed, the date and time of execution. And each such person which accepts the purchase price of the commodity option from the option customer must, upon receipt of confirmation that the order was executed, notify the option customer of the date that the order was executed.

Under proposed section 32.7(e), all the records required to be maintained must be kept for the period specified in regulation § 1.31,[31] which is five years, and must be open to inspection at all times during such time by any authorized representative of the Commission or the United States Department of Justice.

The Commission believes that the records and bookkeeping requirements are important so as to enable the Commission to examine the records of all aspects of commodity option transactions offered and sold to option customers, and to assure that persons maintain proper internal control of their financial operations.

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[30] 17 C. F. R. §§ 1.20(a), 1.25, 1.26(a), 1.27 (a), 1.28, 1.29 and 1.32.

[31] 17 C. F. R. § 1.31.

Unlawful Representations

Proposed section 32.8 makes it unlawful for any futures commission merchant or associated person engaging in commodity option transactions to claim that the Commission, by declaring a registration effective or otherwise, has approved either the registrant or any commodity option transaction to be engaged in by the registrant. While the Commission will seek to prevent the dissemination of false or misleading information by registrants, it cannot conduct an investigation in every instance to determine the accuracy or adequacy of the information contained in an application for registration or in the disclosure statement required by proposed section 32.5 of the interim regulations. Consequently, registration with the Commission cannot, and does not, indicate Commission approval of the registrant or of the transactions in which it may engage. This rule does not preclude a futures commission merchant or associated person from stating that it is registered, if that is true, and if such statement is not misleading under the circumstances in which the statement is made.

Antifraud

Proposed section 32.9, the Commission's antifraud rule governing commodity option transactions, has been included as a part of the proposed interim rules so that all the rules affecting commodity option transactions will be in one place in the *Code of Federal Regulations*. This section is the same rule that is presently in effect, contained in 17 C. F. R. § 30.01, modified to incorporate certain of the definitions set forth in the proposed interim rules. The proposed redesignation of § 30.01 as section 32.9 is technical only; it will have no substantive effect on fraudulent activity prior to, on, or after the effective date of section 32.9.[22]

The Commission wishes to advise affected persons that, upon adoption of the proposed iterim regulations, it would view any attempt to evade their requirements —such as an attempt to avoid the segregation requirements by soliciting options customers in this country and suggesting to the customers that they deal directly with a foreign affiliate of the registrant or other person located outside the United States —as a violation of the antifraud provision.

Option Transactions Entered Into Prior to the Effective Date of the Proposed Interim Regulations

Proposed section 32.10 makes clear that the proposed rules are to have prospective effect only and do not apply to commodity option transactions lawfully entered into prior to the effective date of the rules. However, to the extent stated above, sections 32.2 and 32.9 are codifications of the prohibitions of existing law, so that nothing contained in section 32.10 should be construed to imply that the transactions referred to in sections 32.2 or 32.9 could have been or may be lawfully entered into prior to the effective date of the interim regulations.

Amendments to section 1.17

The Commisison proposes to amend § 1.17 to require that any futures commission merchant engaging in commodity option transactions referred to in Part 32 of the proposed regulations would be required to have and to maintain at all times adjusted working capital equal to or in excess of whichever of the following is greater: (1) $50,000 or (2) the sum of the safety factors described in § 1.17 with respect to both proprietary and customers' accounts plus five percent of the applicant's aggregate indebtedness. A futures commission merchant who is exempt from the financial requirements of § 1.17(a) would also be required to maintain minimum adjusted working capital of at least $50,000, computed in accordance with the bylaws, rules, regulations or resolutions of the contract market which serve as the basis for such exemption.

The Commission believes that the $50,000 adjusted working capital requirement for futures commission merchants engaged in options activity is necessary to provide a cushion against losses which could arise as a result of any number of factors, such as dishonesty, incompetence, insufficient or inadequate segregation.

The Commission also proposes to amend § 1.17(c) to add a new subsection (9) defining the term "customer" to include an "option customer" as defined in the proposed rules. This is necessary to make

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[22] Judicial interpretations of § 31.01 would, of course, continue to be applicable to new section 32.9. See *CFTC v. J. S. Love & Associates Options, Ltd.*, CCH Com. Fut. L. Rep. ¶ 20,198 (S. D. N. Y. Aug. 12, 1976).

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§ 1.17 applicable to commodity option transactions.

* * *

In consideration of the foregoing, the Commission, pursuant to its authority contained in Sections 2(a)(1), 4c(a), 4c(b) and 8a of the Act, 7 U.S.C. §§ 2, 6c(a), 6c(b) and 12a (Supp. IV, 1974), hereby proposes to amend Chapter 1 of Title 17 of the *Code of Federal Regulations* effective November 22, 1976, by amending § 1.3(p) and § 1.17 and by deleting § 30.01 and by adding a new Part 32 as follows:[88]

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. Section 1.3(p) is amended by adding a "(1)" after the word "means" and before the word "individuals", by deleting the period after the word "thereafter" and by adding the following:

§ 1.3 Definitions.

* * *

(p) * * *

(2) shall include any person required to register as a futures commission merchant under the Act by virtue of Part 42 of this chapter.

2. Section 1.17 is amended to revise paragraphs (a) and (b) thereof to read as follows:

§ 1.17 Minimum financial requirements.

(a) Except as provided in paragraphs (b)(1) and (b)(2) of this section, no person applying for registration as a futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) $10,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b)(1) Except as provided in paragraph (b)(2) of this section, no person registered as a futures commission merchant shall engage in commodity option transactions referred to in Part 32 of this chapter unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) $50,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each such person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b)(2) The requirements of paragraphs (a) and (b)(1) of this section shall not be applicable if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting requirements set by such contract market in its bylaws, rules, regulations or resolutions approved by the Commission, *provided, however, that such a futures commission merchant who engages in option transactions referred to in Part 32 of this chapter shall at all times maintain a minimum capital of $50,000 computed in accordance with the applicable bylaws, rules, regulations, or resolutions of such contract market which have been approved by the Commission.*

* * * * *

§ 1.17(c) . . . *(9) the term "customer" shall include an "option customer" as defined in Part 32 of this Chapter.*

PART 30—FRAUD IN CONNECTION WITH COMMODITY TRANSACTIONS

3. Section 30.01 is removed.

§ 30.01 [Removed]

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[88] In proposing the regulations hereinafter set forth, the Commission has, in accordance with Section 15 of the Act, 7 U. S. C. § 19, (Supp. IV, 1974) taken into consideration the public interest to be protected by the antitrust laws. While it recognizes that the financial, segregation and other criteria imposed as prerequisites to allowing a person to enter into or continue in the commodity options business, may result in some lessening of competition, the Commission believes that the proposed rules are a necessary minimum for effectuating the purposes and policies of the Act which require that the Commission assure the financial solvency of option transactions and prevent fraud or manipulation. The Commission has determined that minimum financial and other requirements are essential to public protection under the Act. Accordingly, the Commission believes that, in imposing the minimum financial requirements and the other requirements of the proposed regulations, it has taken the least anticompetitive means of achieving the objectives, policies and purposes of the Act.

PART 32—REGULATION OF COMMODITY OPTION TRANSACTIONS

4. Part 32 is added to read as follows:

§ 32.1 Definitions
§ 32.2 Prohibited transactions
§ 32.3 Unlawful commodity option transactions
§ 32.4 Exemptions
§ 32.5 Disclosure
§ 32.6 Segregation
§ 32.7 Books and Record keeping
§ 32.8 Unlawful representations
§ 32.9 Fraud in connection with commodity option transactions
§ 32.10 Option transactions entered into prior to the effective date of this Part

[Text at ¶ 3430. CCH.]

* * * * *

Interested persons are invited to submit written comments on the proposed rules to the Commission: 2033 K Street, N.W., Washington, D. C. 20581, Attn: Secretariat. All submissions received prior to November 8, 1976 (30 days from the date this notice is published in the Federal Register) will be considered by the Commission in determining whether to revise or modify the proposed rules prior to their adoption or thereafter. Issued in Washington, D. C. on October 4, 1976.

[¶ 20,218] The States' Two-Fold Commodities Enforcement Role: State *Parens Patriae* Suits to Uphold the Commodity Exchange Act and State Prosecutions Under General Criminal Antifraud Statutes.

Commodity Futures Trading Commission, Office of General Counsel. Released October 8 1976. Memorandum to all State Securities Administrators in full text.

Jurisdiction—Preemption of State Regulation—Application of General Criminal Antifraud Statutes to Commodity Transactions—Cooperation Asked.—Despite the fact that the regulation by states of commodity futures transactions has been preempted by the federal Commodity Exchange Act, the Commodity Futures Trading Commission is asking for cooperation from the states in enforcing their general criminal antifraud statutes as they may apply to commodity transaction situations. The Office of General Counsel has stated that it will help to coordinate a joint enforcement effort of the states and the CFTC and will offer advice to the states on novel issues. It is expected that the states will seek injunctive relief where it appears that their criminal antifraud statutes may be violated.

See ¶ 5001, "Commodity Futures Trading Commission" division.

Jurisdiction—States—Enforcement of Commodity Exchange Act Under *Parens Patriae* Doctrine.—States have the right to bring actions to enjoin violations of the Commodity Exchange Act under the doctrine of *parens patriae*, that is, on behalf of the interests of their citizens. According to the CFTC Office of General Counsel, states are preempted from enforcing their own commodities regulatory scheme, but are able to protect their citizens by enforcing the federal Commodity Exchange Act through *parens patriae* suits. A private right of action to enforce provisions of the Act has been recognized, *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N. D. Ill. 1967), and the Commission staff reasons further that actions for injunctive relief brought by States are valid under *parens patriae*. It was added that such actions may properly be brought both in state and federal district courts.

See ¶ 5001, "Commodity Futures Trading Commission" division.

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EXHIBIT "B" TO COMPLAINT

©
Charles J. Hecht
COUNSELOR AT LAW
60 East 42nd Street
New York, N. Y. 10017
Telephone (212) 490-3232

Suite 1760

November 4, 1976

Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581
Attn: Secretariat

Re: Proposed Interim Rules Relating to Commodity Option Transactions

Gentlemen:

In accordance with the notice first published in the Federal Register on October 8, 1976, as counsel to British American Commodity Options Corp., the undersigned hereby submits written comments on the proposed rules. Prior to setting forth my specific comments the undersigned believes certain general comments are appropriate.

Initially, the underlying purpose with respect to the adoption of any regulations relating to commodity options, whether domestic or on a recognized foreign exchange, should be to create public confidence in these particular commodity markets and to foster the maturity of a relatively new industry in this country. In the opinion of the undersigned, the proposed regulations are clearly contrary to the basic underlying legislative history relating to the adoption of the 1974 amendments to the Commodity Exchange Act and are a poorly disguised attempt to realign the industry so that only a few large full-service brokerage houses will have a monopoly. Accordingly, the effect of the implementation of the proposed regulations would be clearly contrary to the anti-trust laws as set forth in 7 U.S.C. ¶19 (Supp. IV, 1974) and in the long run detrimental to the general public and the vitality of this industry.

Secondly, the basic underlying assumption implicit in the proposed regulations that the International Commodities Clearing House ("ICCH") and the London Metal Exchange ("LME") do not provide sufficient safeguards to commodity option purchasers residing in the United States is not legally or factually supportable and, thus, the segregation requirements contained in the proposed regulations represent an unrealistic and improper approach from both the investing public's point of view and making commodity options competitive with commodity futures contracts or with securities and other forms of investment. Finally, as hereinafter set forth in greater detail, the proposed rules are totally unworkable in a number of areas.

In view of the foregoing and the specific comments set forth below, as well as the importance of such proposals, the undersigned in accordance with the applicable provisions of the Administrative Procedure Act respectfully requests that the Commodity Futures Trading Commission authorize public hearings or, if appropriate, an administrative proceeding prior to the adoption of these proposed rules. In view of the fact that there is a time limit of November 22, 1976, the undersigned respectfully requests that the Commission promptly notify him of what actions it intends to take with respect to the proposed rules in light of the comments submitted by interested parties prior to that date, so that my client and other persons similarly situated are in a position to pursue their appropriate remedies.

REGISTRATION PROVISIONS

As presently worded, the proposed rule is totally unworkable. Under the proposed regulatory scheme, companies such as British American Commodity Options Corp. ("British American") will be required to register as futures commission merchants ("FCM"). However, Reg. 1.19 stated that it shall be unlawful for any FCM to deal in commodity options if (i) such entity is an issuer of the option or (ii) such entity "otherwise assumes financial responsibility" for a commodity option transaction. Even though a company such as British American clears through a member of the ICCH or LME under the present structure of the industry, it could be construed that British American is "otherwise assuming financial responsibility" since it receives the customer's funds in payment for the commodity option and subsequently transmits a substantial portion of such funds (the "premium") to the clearing members of the ICCH. Thus, it could be argued that such an entity "otherwise assumes financial responsibility by contract or by operation of law" for a commodity option transaction. Paranthetically, if such a dealer writes naked options, Reg. 1.19 would not pose any problem although past history has shown how the general public has been harmed by naked options. The Commission's refusal to repeal Reg. 1.19 represents the ultimate "Catch-22" since in one breath it is requiring commodity options dealers to register as FCMs and at the same time stating that it shall be unlawful for an FCM to transact commodity options business. In view of the foregoing, prior hereto, the undersigned has advised the staff that British American intends to file a registration application as an FCM conditional upon repeal of Reg. 1.19 or in the alternative, that it be exempted from Reg. 1.19 since it began operation prior to October 7, 1976.

There are certain other relevant considerations which should be set forth with respect to the registration of associated persons. In the first place, as presently framed, the regulations are unworkable since, as a practical matter, they will seriously impede the attraction of new employees to this industry. In the second place, the regulations should provide that each associated person pass an examination which in the long run will benefit the general public and the industry.

Consistent with the Advisory Committee Report it is respectfully suggested that the agency and the industry set up a task force to design an appropriate examination to be administered by the industry subject to review by the agency. Further, the rules should provide that until a person passes such examination he shall be prohibited from directly or indirectly being involved with the sale of commodity options to the general public. However, once such person has passed the examination, he should be granted provisional registration automatically, subject to the Commission instituting an appropriate administrative proceeding. If this is not done, the staff of the Commission will be in a position to delay the registration of an associated person through the mere institution of an administrative proceeding and, thus, as a practical matter, effectively deny a person becoming engaged in this industry without any proof of wrongdoing by such person. Reference is made to the recent decision by the United States District Court for the Southern District of New York in CFTC v. British American Commodity Options Corp. (76 C v 3247), and the related case pending where the staff made certain allegations as to the conduct of a registrant's business methods in its Administrative Complaint and Notice of Hearing and publicized such charges in the media; thereafter the staff attempted to obtain information to support its allegations; and then the staff subsequently took the position in an injunctive action that since the company was not yet registered it should be put out of business until the administrative process was completed.

SEGREGATION

The proposed regulations present a totally unworkable and impracticable approach to the alleged need for additional customer protection. Implicit in this proposal is the basic assumption that neither the ICCH nor the LME provide meaningful financial protections for the beneficial owners of commodity options purchased through those exchanges. No factual basis is set forth by the Commission for this assumption, and to this writer's knowledge, in the past 100 years there has never been a default by any member of either of those exchanges with respect to commodity options. It is this writer's understanding that the ICCH registers each option and, where appropriate, the underlying futures contract on its books setting forth the date and time of execution, the expiration date and the commodity and name or names or the broker or brokers on both sides of the transaction. Furthermore, not only must the clearing member through whom the option is initially sold leave the premium intact until the option expires or is closed out but the member who has written the option must mark to market his open positions at the close of business on each day. With respect to the ICCH under its bylaws the clearing house guarantees fulfillment of each futures option. With respect to the LME, the fulfillment of each futures option is the responsibility of one of its 33 members and each of those members is required to post a substantial bond. In any event, efforts should be made by the CFTC to obtain permission to conduct reasonable inspections to insure that the ICCH and LME will maintain such safeguards.

In this connection, it is this writer's understanding that members of such exchanges were supposed to meet with the Commission on October 21, 1976 but the meeting was cancelled without comment. However, in subsequent conversations the undersigned was advised by the ICCH that under existing law in the United Kingdom, the funds cannot be transferred to the United States as required by these proposed regulations. Accordingly, as presently drafted, the proposed rules would, in effect, require double segregation.

The Commission's comment that such "double segregation" may impose a financial hardship is a gross understatement. The following example shows how the segregation requirements would work under the proposed rules and illustrates their basic impracticability and unfairness, especially as to the small specialty firm which presently does a significant portion of the domestic business in London commodity options. Unfortunately, everyone has assumed the ICCH and the LME can work out an arrangement so that option premiums can be maintained in waivered United States bank account when, in fact, this assumption may well be unworkable. Therefore, the proposed rules should be analyzed under two specific factual frameworks: (i) that no arrangement for waivered United States bank accounts can be worked out and (ii) that such arrangements can be made.

Under the first factual framework the rules are impossible to comply with. Solely for analytical purposes, let us assume the following breakdown in costs to the option customer:

1.	Option premium	$2,000
2.	Executing broker's commission	200
3.	Gross commission of specialty commodity firm of which $600 is required as sales commissions, back office and general overhead	800
	PURCHASE PRICE	$3,000[1]

Accordingly for every $3,000 option purchase, the commodity option dealer will have to immediately spend $5,800 as follows: (i) $2,000 for the option premium; (ii) $200 to the executing broker; (iii) $600 for operating expenses and (iv) $3,000 to the segregated account.[2] Restated in terms of net cash flow

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1. Under proposed Rule 32.1(d) the "purchase price" would be $3,000 which is the total cost to the customer.

2. There are no offset provisions or mark to market adjustments permitted and those funds must remain there until the option lapses or is closed out.

for each $1,000 in gross revenues a dealer would be required to immediately pay out $3,800. Not even General Motors would be able to survive under this regulatory framework for any meaningful period of time.

To continue in operation, the commodity option dealer would have to obtain such funds from working capital which is clearly self-destructive, or obtain suitable financing to satisfy the segregation requirements.

Even if the commodity options specialist could obtain financing it could also result in a negative cash flow. The commodity option dealer would still have to pay selling and administrative expenses, estimated at $600 on this transaction, plus $200 to the executing broker plus the financing charge imposed by the clearing member firm or other intermediary source of financing. Under this set of circumstances the cost of financing $2,800 for the term of the option would probably exceed his total gross profit of $200. Ultimately, to survive such a charge must be passed on to the consumer resulting in an even larger spread between the retail prices charged by the executing broker if he elects to engage in retailing under the new regulatory scheme and a commodity option specialist who has already gone to the substantial expense of aggressively marketing this form of investment to make it a meaningful factor in the investment community. In the long run this will result in the total destruction of meaningful competition for the benefit of a few large broker-dealers and the detriment of the general public. Query, how much will such large firms raise their commissions once they are the only game in town? Query, their interest on this area when the stock market again becomes popular? Query, whether this is intended to make London options non-competitive with domestic options, when and if trading is permitted in domestic options?

Under these proposed rules, the Commission has assumed that the commodity option dealer should only pay its salesmen or back office personnel when the option contract is either exercised or expires, which is apparently when commissions are payable to brokers in commodity futures transactions. This assumption is clearly improper as to the commodity option dealer and fails to recognize certain basic distinctions between commodity options dealers and the operations of an FCM who is engaged in the sale of futures contracts on margin. With respect to commodity options this is a one-time investment for one commission over a substantial period of time and it is in the customer's best interest to have the longest term option possible. This type of investment is clearly not suitable for rapid turnover as in the case of futures contracts and, thus, as a practical matter there is not an incentive on the part of the dealer to close out a transaction in a few days to realize his commissions. Short-term commodity options, which are clearly not in the general public's best interest is in the FCM's best interests under these proposed rules.

Secondly, options, unlike futures contracts are not subject to margin and thus have limited risk to the customer. Third, the vendor of futures contracts has the benefit of free credit balances which is not available to the commodity option dealer.[3] The free credit balances on futures contracts are created by the difference between the funds provided by customers and the funds which the FCM is required to put up with the domestic exchange, after netting out its position with that exchange. It is well known in the brokerage industry that the use of such free credit balances by large brokerage firms is used to generate substantial profits for such firms. Fourth, when the foregoing is combined with the discriminatory disclosure requirements applicable to commodity option dealers, as hereinafter described, it is clearly inequitable and improper to superimpose such a commission payment schedule as to employees of commodity options dealers. The result will be the immediate destruction of the sales forces developed by these companies unless the dealer can churn his customers' accounts to free up cash to pay his operating expenses.

Under the second set of circumstances the only difference would be that the specialist's firm's initial expenditures or initial principal amount of financing would be reduced by $2,000. Accordingly, the negative effects on cash flow, competition and the public interest would be the same although it would take a little longer to accomplish.

It is obvious that the real beneficiaries of the proposed regulations are a few large diversified securities firms who would now like to add another product line after the small specialty firms such as British American, through the use of their own capital and energies, developed the popularity of London commodity options in this country when everyone else chose not to take such financial and other risks. Accordingly, it was not surprising when E.F. Hutton announced in the financial section of the New York Times on November 1, 1976 that they are in favor of the proposed regulations and if adopted will become involved in the retail sale of London

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3. No offsets are permitted under the proposed rules.

commodity options.

In connection with the proposed rules, a historical review of firms engaged in London commodity options since the adoption of the 1974 amendments, shows that the alleged assumptions requiring this approach are non-existent. There have been two major failures of commodity option firms: United Kingdom in Memphis, Tennessee and J.S. Love in New York. Both of these failures were totally unrelated to the financial protections afforded by the ICCH and LME or the method of operations of reputable members of this industry. As to United Kingdom, it is this writer's understanding that the basic problem was that that company was writing naked options. As to J.S. Love, although naked options were not a primary cause of its financial problems, it was a part thereof. But the main cause was that J.S. Love had invested in unrelated enterprises which subsequently failed, resulting in its financial insolvency and inability to close out customers' options. The proposed regulations would be ineffective against this type of business conduct. The Commission's proposal represents decapitation to cure a headache. As an alternative, it would appear that under the present factual situation, the appropriate recourse is for the Commission to establish a higher net working capital requirement, such as $100,000, and properly supervise the industry through its inspection powers and appropriate recordkeeping requirements.

In connection with computing adjusted net capital, there is a basic distinction between a dealer who trades in options for its own account or trades against its customers, as distinguished from a dealer who is primarily engaged in the retail sale of London commodity options which the proposed rules do not take into account. As to the former, it is respectfully suggested that the CFTC follow the precedent utilized by the brokerage industry which requires a dealer to mark to market with appropriate haircuts, all security positions in the firm's trading account. Thus, if a commodity option dealer elects to engage in substantial trading in commodity options for its own account or against its customers, which could imperil its financial stability to the detriment of its customers, he should adjust his net capital appropriately. However, as to a dealer who does not engage in such activities, it serves no useful purpose for that dealer to adjust his net working capital since, as a practical matter, he is not directly or indirectly assuming financial responsibility for the customer's options or the underlying futures commodity contract.

In addition, as much as seven months ago, the undersigned suggested to the CFTC that they should investigate the possibility of coming under SIPC or the formation of a similar quasi-governmental institution to guarantee or underwrite customer losses resulting from the financial insolvency of any FCM. The possibility of obtaining appropriate insurance and fidelity bonding was also suggested. Apparently, the Commission has elected to ignore these requests which offer a viable solution to the general public and the industry. The undersigned believes that this was either a serious mistake or is another indication of their attitude towards the present participants in this industry and the use of London commodity options as a viable investment technique.

DISCLOSURE REQUIREMENTS

The disclosure requirements, as proposed by the Commission, are clearly anti-competitive for commodity options compared to other forms of investment, including futures commodities contracts. They also illustrate a complete lack of understanding as to the basic nature of the business. Unlike futures commodity contracts, commodity options may not be traded over the short-term as it is clearly contrary to the customer's interest. Thus, although at first glance the commission structure appears to be unfair, in the long run the present commission structure as to commodity options compares favorably with the total commissions which a person would pay in trading futures contracts with the same amount of invested capital over the same period of time.

The disclosure statement which the Commission is requiring as to commodity options is unlike anything in the entire investment community. Why hasn't the Commission proposed the same disclosure requirements for persons trading in futures commodities contracts? The reason is very simple--they would like to destroy this business thus leaving a few limited large "full-service" commodity houses who can then charge what they desire once there is no competition. The bold face legend is a paraphrase of the legend set forth in a prospectus with respect to the sale of securities under the Securities Act of 1933, as amended, albeit a biased paraphrase. As between futures contracts and commodity options, the former is far riskier but offers greater leverage.
Commodity options are not subject to potential margin calls or margin charges. An investor in commodities futures can lose far more than the amount of his original investment. The owner of a commodity option can effectively use a stop

loss order while such a technique is not necessarily available as to ommodity futures contracts. The choice of whether to invest in commodity options or commodity futures contracts should be made by the investing public, and to the dismay of the CFTC and the large brokerage firms, many persons are investing in commodity options. The "disclosure requirements" proposed by the Commission, which are only applicable to commodity options, is the Commission's way of telling the investing public that they should opt for commodities futures rather than commodity options. On its face this is improper.

Certain of the proposed disclosure requirements set forth in ¶32.5 are clearly impracticable and unworkable because of the volatile nature of commodities markets and exactly when a customer's funds are received by a dealer: (i) advising a customer 24 hours prior to the entry into a commodity option transaction of the actual purchase price and the elements comprising such purchase price; (ii) advising a customer 24 hours prior to entry of the order of the striking price and the method by which the striking price is established; and (iii) separately stating the storage and interest costs since they are a factor, along with the current price of the underlying commodity, taken into account by the writer of the option in setting the premium to be charged for a particular option.

The Commission's attempt to require a statement as to the dealer's markup is clearly contrary to the underlying legislative history which indicates that the CFTC has no authority to regulate the rate of commissions charged by persons selling commodity options or commodity futures contracts. The Commission is indirectly attempting to do what it is directly prohibited from doing and, thus, such a proposal in the name of "disclosure" amends the statute without the requisite congressional approval. Markup was always intended to be a matter of competition and the customer can always compare prices charged by various dealers.

It is respectfully suggested that substantially all of the disclosure requirements can be adequately covered by the general anti-fraud provisions, if properly and vigorously enforced, which are very broad and pervasive without requiring the generation of all of this additional paperwork which obviously is not required. Submitted as a supplemental attachment will be a proposed legend which the undersigned suggests should be placed on the back of each and every confirmation slip, whether representing an open order or actual execution of an order. Furthermore, as pointed out by the Advisory Committee

Report, any such disclosure statements must be accompanied by a vigorous program to educate the public about the commodity futures markets or the commodity option markets. Obviously the Commission has not considered such a program in adopting its disclosure requirements for commodity options as the true purpose of these proposed regulations is self-evident--the elimination of competition for the benefit of the privileged few to the long-term detriment of the general public and the companies which were responsible for popularizing this form of investment. The best example of the need for a proper educational program to remedy the total lack of understanding of this form of investment is the November 1, 1976 article at page 66 of the New York Times. In this connection it should be pointed out that the effect of foreign currency fluctuations as to the British pound are not so readily apparent.

Even though the pound may be devalued during the term of the option contract, the U.S. customer's loss on conversion of pounds to dollars may be more than offset by the increase in price of the underlying commodity in the world markets. Thus, as to recent activity in coffee options the U.S. customer actually benefited. The risk of devaluation to the customer which can or should be put in any disclosure statement is that between the execution of his order closing out the transaction and the subsequent conversion of pounds to dollars, he bears the risk as well as the potential gain as to currency revaluations. As the Commission is well aware, with respect to the customers of British American, substantially more than 50% of such customers have engaged in such transactions profitably over the last year. This should be compared to the performance of investors who have traded in commodity futures contracts over the last year.

RECORDKEEPING

The requirement that a commodity option dealer must furnish the names and addresses of each "prospective commodity option customer solicited" is ridiculous. No such requirement is applicable to purveyors of futures contracts, securities or any other form of investment. In addition, the requirement in subparagraph (b) of ¶32.7 as to "each maker, underwriter, issuer or other person who assumes or purports to any financial responsibility as to any solicited or accepted order" is impracticable and has no relevance as to the ICCH since that exchange guarantees the fulfillment of each option sold through its members, or to the LME since the members' guarantee of fulfillment of each option is backed by a substantial bond. Finally, the undersigned respectfully suggests that the record retention requirements suggested by the Advisory Committee (one year on premises plus two years off premises) is far more practicable and would not be inconsistent with the overall statutory purpose of the Commodity Exchange Act, as amended.

CONCLUSION

In view of the foregoing, the undersigned respectfully requests a prompt response.

Respectfully submitted,

Charles J. Hecht

Charles J. Hecht

CJH/gk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO., Plaintiffs, - against - WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION, JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS, and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION, Defendants.	AFFIDAVIT OF CHARLES J. HECHT IN SUPPORT OF A TEMPORARY RESTRAINING ORDER AND PRELIMINARY INJUNCTION

State of New York)
) SS.:
County of New York)

CHARLES J. HECHT, being duly sworn, deposes and says:

1. I am the attorney for the plaintiffs herein and submit this affidavit in support of plaintiffs' request for a temporary restraining order and preliminary injunction.

2. The substance of my position is summarized in my comment letter dated November 4, 1976, which was received by the Commodity Futures Trading Commission on November 5, 1976. A review of that letter clearly shows that the proposed regulations are "(i) arbitrary, capricious and a clear abuse of discretion; (ii) discriminatory; (iii) beyond the scope of the authority of the CFTC; (iv) clearly anti-competitive in direct contravention of 7 U.S.C. ¶19 (Supp. IV, 1974) and do not con-

stitute proper notice since there is not a proper opportunity for participation in the rulemaking process."

3. Deponent respectfully directs the Court to the first full paragraph on page two pursuant to which deponent requested the Commodity Futures Trading Commision (the "CFTC") to "authorize public hearings or, if appropriate, an administrative proceeding prior to the implementation or adoption of these proposed rules." At six-twenty p.m. on Thursday, November 11, 1976, the undersigned received a telephone call from Howard Schneider, General Counsel to the CFTC, Frederic Spindel, Assistant General Counsel of the CFTC and Charles Harris, Special Counsel to the Division of Enforcement wherein he was notified that not only would the Commission not hold any public hearings or administrative proceeding with respect to these "proposed" regulations relating to commodity option transactions, but that there would be absolutely no delay in the implementation and enforcement of these regulations on November 22, 1976.

4. Mr. Schneider also stated that although deponent's comment letter raised many valid points, it was contrary to the basic philosophy of the CFTC and that the CFTC was going to do what it had planned to do all along and that this left us no alternative but to seek our legal remedies. At this juncture, I pointed out that the CFTC and the appropriate exchanges in London had apparently not worked out any agreement and that the practical effect of these regulations was to immediately put not only my clients but other members of the industry out of business since under the segregation rules, it was clear that

it is not economically feasible for them to remain in business. Consistent with its prior practice, the CFTC has no concern for the rights of the employees of British American, Lloyd, Carr & Co. and the other companies engaged in this industry or its many customers. To them, it is paramount that this business be immediately abolished although there is no factual basis to support their position. Even worse, it is clear that there is no legal basis to support their actions.

CJH

5. Accordingly, the plaintiffs have no alternative but to come into federal court to seek a declaratory judgment and pending such determination, to restrain the CFTC from implementing and enforcing these "proposed" regulations.

6. In this connection, it is important to note that although the CFTC requested comments, this was apparently "eyewash" since the facts now indicate that the CFTC never had any intention of permitting the industry or the general public to participate in the formulation of these regulations, for if they had, it is clear that these regulations would never have been enacted along the lines "proposed" by this agency.

WHEREFORE, the undersigned respectfully requests that this Court temporarily restrain and then preliminarily enjoin the Commodity Futures Trading Commission from implementing and enforcing these "proposed" regulations.

Charles J. Hecht

Charles J. Hecht, Esq.
Attorney for Plaintiffs

Sworn to before me this
15th day of November, 1976.

Kathryn Lane
Notary Public

KATHRYN LANE
NOTARY PUBLIC, State of New York
No. [illegible]-7[illegible]0925
Qualified in Queens County
Cert. Filed in New York County
Term Expires March 30, 1978

AFFIDAVIT OF JAMES CARR

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS, and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

AFFIDAVIT OF JAMES CARR IN SUPPORT OF TEMPORARY RESTRAINING ORDER AND PRELIMINARY INJUNCTION

State of New York)
) SS.:
County of New York)

JAMES CARR, being duly sworn, deposes and says:

1. I am the President and sole proprietor of Lloyd, Carr & Co., a dealer in London commodity options whose principal office is located in Boston, Massachusetts and submit this affidavit in support of plaintiffs' request for a temporary restraining order and preliminary injunction.

2. Lloyd, Carr & Co. was formed in July, 1976 and its sole business is the retail sale of London commodity options through the International Commodity Clearing House (the "ICCH") and the London Metals Exchange ("LME").

3. At the time my company was formed and subsequent thereto, the CFTC has published certain proposed regulations with

respect to commodity option transactions and throughout this period, up until October 8, 1976, my firm and its employees at all times attempted to comply with these proposed regulations even though they were not enacted.

4. Throughout this period there was no indication by the CFTC or any other regulatory agency that the absurd rules first proposed on October 8, 1976, which ran contrary to every other published proposed rule or regulation relating to commodity options prior to that date, was even being considered by the CFTC.

5. Because the CFTC has obviously decided to rush these through with the minimal time for comments or for this industry to take any action, these rules were first published in the Federal Register on October 8, 1976, which is a Friday, and comments had to be submitted prior to November 5, which is a Monday, which in effect made the notice period only 24 days. Then, they tried to play down the publication of these rules and it was only through the Reuters News Service and some inquisitive lawyers who thought something "fishy" was going on that these proposed rules first became generally available. It is my understanding that they were subsequently published in CCH around the last week in October, which is when I first became aware of these rules.

6. When deponent first read these rules, it appeared to him that the CFTC did not have the foggiest notion of the mechanics of London commodity options.

7. Each time deponent read the proposed regulations, it became more apparent than ever that the sole purpose of these regulations was to impose a structure on the retail London commodity option business as it now exists so that it would be absolutely impossible for my company and other companies similarly situated, to operate.

8. Not only are these proposed regulations arbitrary, capricious and a clear abuse of discretion, they are clearly discriminatory as to the existing retail dealer in London commodity options. A classic example of this is to require us to register as futures commission merchants, although in the past the staff has indicated that we should register as commodity trading advisors, but at the same time, the pre-existing regulations prohibit legitimate futures commission merchants from dealing in London commodity options. The only exception under the new rules is the unethical commodity option dealer who takes a customer's money and then does not forward the premium to the option rider, which is commonly called a naked-option, which is the very reason the Commodity Exchange Act was amended in 1974.

9. The segregation requirements of the proposed rules, which will automatically become effective on November 22, 1976, will immediately require the entire industry to cease operations as the practical effect is that for each one dollar in sales, our company will be required to put up three dollars in cash until the option expires, or is exercised. The Commission's alleged rationale is this is needed for the protection of the customers. However, the prior history of this industry indicates

that that is absolutely not the case. Two companies, United Kingdom in Memphis, Tennessee, and J.S. Love & Co. in New York became financially insolvent. However, the insolvencies of these companies were totally unrelated to the purportedly abuses that the CFTC says has forced them to adopt the segregation requirements. In both of these situations, the companies were writing naked-options and in the J.S. Love situation, this was aggravated by the fact that J.S. Love was investing its capital in unprofitable, unrelated businesses. When these companies went under, the fact that the customers may not have been protected was due solely to the insufficient net working capital of these companies and the fact that the CFTC had permitted them to write naked-options. However, the CFTC well knows that substantially all of the members in this industry do not write any naked-options and as to them, there has never been a default in any customer obligations.

10. The CFTC's rush to implement these "proposed" rules is being supplemented by a false and misleading press campaign by their public relations department wherein they have stated that everyone now engaged in this industry is a "boiler-room operation". But, the facts are to the contrary. In the two litigated injunctive proceedings under the Commodity Exchange Act of 1974, as amended (the "Act") the CFTC's request for an injunction was denied. Both of these cases were in the United States District Court for the Southern District of New York. In the first case, CFTC v. J.S. Love & Associates, et al., the

one party who litigated the case was found to have violated the existing anti-fraud statutes in the dissemination of false and misleading advertising, but the court held that an injunction should be denied. In the second case, entitled Commodity Futures Trading Commission v. British American Commodity Options Corp., which is the other plaintiff herein, not only was the CFTC's request for a preliminary injunction denied by way of a directed verdict, the court specifically found that there was no proof of fraud or any proof that the company was misleading its customers or the general public and that the company was engaged in legitimate business activities. The simple fact is that none of the reputable members of this industry deny the fact that regulation is appropriate, but what the CFTC is attempting to do is to put out the entire business, as it now exists, for a few large securities dealers. It is ironic that a new political party has come into power and the timing of these regulations would seem to indicate that persons employed by the CFTC are already looking for jobs with these companies.

11. What makes the situation even worse is that it was small companies like ours and British American Commodity Options Corp. which risked their capital and invested substantial sums of money to develop this business and make London commodity options a popular investment vehicle in this country. Now that we have brought the industry to this stage, the big brokerage firms which have been sitting on the sidelines or acting as wholesalers for us now want to step into the arena. Not being satisfied with their substantial capital advantages, they wish to put us

immediately out of business so that they can get hold of our customers' list, which has cost us many millions of dollars to create, at no cost to them. Then not only do they have the bread and butter, but they also get the gravy. Not only are the proposed regulations clearly anti-competitive, they are also discriminatory. This represents the great American ripoff and should not be tolerated by anyone.

12. It is my understanding that various parties have commented to the CFTC and the CFTC has uniformly told everyone, in effect, we don't give a hoot what you say, the segregation requirements are going into effect on November 22, 1976. In fact, our counsel has advised us that he made a formal written request for a public hearing or an administrative proceeding with respect to these proposed regulations and was orally advised by the CFTC that although there had been many comments, none of these comments would change their minds and that they were going ahead on schedule without authorizing a public hearing or an appropriate administrative proceeding.

13. What makes this situation even more ludicrous is that members of the industry have proposed viable alternatives, such as increased net working capital requirements, appropriate insurance and bonding, and cooperation with the Securities Investors Protection Corporation, which is a quasi-governmental organization set up to protect the customers of brokerage houses which suffer financial difficulties and are unable to satisfy their obligations to customers. Unfortunately, not only has

the CFTC ignored these recommendations, they have not had the dignity to even respond to such suggestions, which do offer a viable method of protecting the retail customers and at the same time permitting members of the industry to continue to provide a meaningful investment vehicle to the general public.

14. The disclosure requirements are arbitrary, discriminatory, and an abuse of discretion beyond the scope of the authority of the Commodity Futures Trading Commission and clearly anti-competitive. No other investment media is saddled with such a disclosure requirement and in many instances the disclosures cannot be made because the CFTC is requiring you do disclose something which you do not know 24 hours in advance. They are also clearly unfair to the industry and misleading to the general public. Clearly, the first question is, why haven't they imposed the same disclosure requirements on dealers in futures commodity contracts on margin, which is a far more speculative investment than London commodity options? The answer, simple: the CFTC has never really understood London commodity options as an investment vehicle and in the past has made known its bias and prejudice towards this aspect of the industry through its various and sundry press releases. The irony of this situation is that the Act was specifically amended so that there would be a federal agency which would have the necessary power to properly regulate this industry. The CFTC's definition of regulation is the classic police-state tactic: destroy those who disagree with you even though they may be right. Rather than attempting to properly regulate this industry for

the protection of the general public, it has abdicated its regulatory responsibilities and is attempting to cover-up their inadequacy by proposing regulations which would put the entire industry out of business.

15. However, for the last two years, they have not only permitted this industry to operate, but this industry has grown to be a substantial factor in the investment community and a substantial portion of the persons who are engaged in the purchase and sale of London commodity options were formerly customers of brokerage houses. Now the brokerage houses, in view of a slow securities market, are concerned about this loss of business and the proposed regulations hand this business over to them on a silver platter.

16. Attached hereto is a representative sample of the press releases and articles being disseminated by the CFTC wherein such broadsides are being indiscriminately hurled at everyone in the industry, such as "hot check artists," "crooks," "boiler room operators." Deponent has never been the subject of any inquiry of any kind from any governmental agency and to my knowledge there has never been even one complaint as to me, my company, or any other of the thirty employees of the company. I thought the McCarthy era of finding Communists under every chair and table and guilt by association was happily a thing of the past.

17. The foregoing is only a brief summary of some of the major drawbacks to these "proposed" regulations which the CFTC is attempting to rush through before everyone wakes up to

the fact that an entire industry is being arbitrarily and wrongfully eliminated at the whim of the bureaucracy. What this industry needs is proper and rational regulation and a suitable educational program for the general public so that all parties, including the regulatory agency, thoroughly understand all aspects of London commodity options so that intelligent regulatory and investment decisions can be made by all parties concerned.

WHEREFORE, the undersigned respectfully requests that this Court execute the temporary restraining order submitted herewith, grant declaratory relief on the various issues raised in the Complaint and temporarily and permanently enjoin the Commodity Futures Trading Commission from implementing and enforcing the proposed regulations relating to commodity options transactions in their present form.

James A. Carr
James Carr
President, Lloyd, Carr & Co.

Sworn to before me this
15th day of November, 1976.

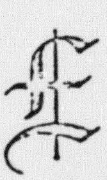
Charles J. Hecht
Notary Public

CHARLES J. HECHT
Notary Public State of New York
No. 52-[illegible]
Qualified in [illegible] County
Term Expires March 30, 1977

member of the ICCH or LME or is closely associated with either. Also he should be sure that the option premiums charged are not too far out of line with the price he is being charged in the U.S. He must also establish how long his own broker/agent has been formed. What is his track record? What is the background of the directors or partners? What is the company's paid-up capital?

The company which has been established for some considerable time and has built up a reputation for fair dealing is a much better bet than the business that has sprung up overnight offering all the riches of the Orient in exchange for your hard-earned capital.

In the English-speaking world, there is an old adage which goes, "A fool and his money are easily parted." It might be an old saying, but it is obviously suited to the times we live in, too. □



prices. Second, they don't know where to go even if they did know about the lower premiums. Third, if they did know where to go, it is unlikely that the London house would be interested in dealing with an individual in the U.S. because of the cost of communication. If it did, the client would have to get up early in the morning, make his own phone call and make his own arrangements for the transfer of funds to a London bank, etc.

"In short, the problems of taking credit references out on individuals are simply too expensive for the London houses. It is logical, therefore, to transact business through retail commission organizations.

"If the American commission houses were to pay some attention to London

(please turn to page 34)

Rainbolt: *We have to get the crooks out first*

Is trading in London commodity options about to be wiped out by new CFTC regulations coming into effect? For some, it very well could be and for very good reason, CFTC officials contend.

Commodity options have become a very hot item in the U.S. recently, leading to some reports of abuses and ripoffs by some firms who charge high premiums and provide little protection for the customers' funds.

As the CFTC moved toward regulatory controls which will eventually lead to trading in domestic commodity options, there were two areas of confusion in proposed CFTC regulations on commodity options.

One involves the status of the Futures Commission Merchant (FCM) and whether he's eligible to handle commodity options. One provision apparently says all options dealers must register as FCMs; but another section says FCMs are prohibited from handling options. CFTC officials say that interpretation is a misreading of the regulations and is not in line with policies outlined several years ago.

"This is not a problem as far as we're concerned at this time," CFTC Commissioner John Rainbolt told COMMODITIES in mid-October. Previous opinions by Alex Caldwell, head of the old CEA before its duties were taken over by CFTC, indicate that the regulations do *not* prohibit anybody from being a broker for London options. CFTC's gone along with that thinking since and sees no trouble allowing the FCM to sell options although requirements for becoming a registered FCM might eliminate some potential traders.

Segregated Funds Big Question

The other confusing area is segregation of customer funds and keeping them in the U.S. That *does* pose a problem for the near-term future of London commodity options trading in the U.S.

"We're looking carefully at the new rules to see whether we can comply," an official at one of the top options firms in the U.S. told COMMODITIES, "but I would bet that not more than five firms in the whole country can survive the new regulations in their current firm. It's like using a pile driver when a hammer would have been enough."

If the rule does go into effect as at first proposed, it would mean that options firms would have to have two accounts to trade options, one in London to acquire the option and the other in the U.S. to serve as a customer protection fund. Few options firms have that kind of extra money available to put up double premiums, and few would be willing or able to go to the bank to get such financing. London officials were to meet with CFTC officials in late October to consider some ideas on how funds might be segregated in London rather than in the U.S., but Rainbolt was not convinced that any alternatives presented ahead of that meeting were acceptable.

Squeeze on Crooks

The proposed segregated fund rule would really put the squeeze on the smaller options firms. That would suit Rainbolt.

"We have got to clean up the options business in this country first — you have to get the crooks, the bunko artists, the hot check artists out," he emphasizes. "You have to squeeze the business dry. I'm concerned that the segregation thing is going to be hard for some people in the business. But I know it's going to be a lot harder for the little guy than it is the big guys. And I know the little guys in this business are generally the ones ripping off the public — I know some big ones are doing it, too. The real problems are the fly-by-night operators, and you've got to get them out. At the same time, if you're going to leave them in, you have to provide some basic rudimentary customer protection which we don't have now. And a basic tenet of the commodities industry has always been the segregated fund.

"When all this goes into effect, we get the business cleaned up and traders are all registered, then we can begin talking about something," says Rainbolt.

At that point, it would be time to consider domestic commodity options trading on contract markets. Early 1977? It's too early to say, according to Rainbolt, who points out that a number of details still have to be studied more thoroughly to see if options are a viable and desirable trading tool. □

NOVEMBER 1976 Commodities

(6)

EXHIBIT TO AFFIDAVIT OF JAMES CARR

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BOSTON GLOBE

Commission hopes new laws curb commodity sale abuses

By Laurence Collins
and Susan Trausch
Globe Staff

The Commodity Futures Trading Commission (CFTC) is counting on recently issued regulations rather than prolonged court action to clean up widescale abuses by dealers in commodity options.

The regulations, which become effective Nov. 22, include provisions which many commodity option dealers would find difficult to live with.

John V. Rainbolt 2d, vice chairman of the CFTC, said this week: "Our strategy is to clean up this business. If people can meet our requirements, more power to them."

However, Rainbolt added, if some commodity option firms are forced to close, "in all probability they deserve to go out of business . . . ."

"The commission is not going to budge just because a lot of undercapitalized option firms are unhappy."

Commodity options, which are sold for several thousand dollars each, are rights to buy or sell commodity future contracts. Although banned on US exchanges since the 1930s, commodity options are available on foreign exchanges, chiefly in London. It is the so-called "London options," often sold by "boiler room" operations reminiscent of the 1920s, that prompted the new CFTC regulations.

Commodity options have been the focus of numerous investigations by the CFTC, but the agency has been criticized by legislators in Washington and by state law enforcement officials for not cracking down on the widespread abuses it has uncovered.

In recent months The Globe has published numerous articles dealing with Boston commodity option firms. Articles on two of them — London Commodity House and First Commodity Corp. — disclosed among other practices, the consistent use of high pressure sales techniques and misleading claims concerning risks and possible investment return on commodity options.

Sources at the CFTC have indicated that both Boston firms, and possibly some of the other six now operating in the city, have been included in the CFTC investigations. However, despite CFTC assurances as late as two months ago that action against at least one Boston firm was imminent, no action has yet been taken.

Last month the CFTC did file suit against a Chicago firm dealing in Commodity options — Rosenthal & Co. — charging the company with "cheating, defrauding and deceiving" customers who had bought London commodity options. The suit now is pending in US District Court in Chicago.

Rainbolt said the CFTC went ahead with its suit against Rosenthal & Co. because of its size — the company operates more than 30 branch offices — "and the fact that they've been around awhile and are well capitalized."

The regulations will have their greatest impact on the dozens of option dealers that have emerged in the past year or so, many of which are poorly capitalized, according to CFTC officials. Since some of the key provisions of the CFTC regulations will require substantial cash reserves, many options dealers will be forced to shut down.

CFTC officials are reluctant to say outright that this was their intention. Rainbolt, for example, put it this way: "I'm afraid I have to rise to my full bureaucratic height on that one. It would be reasonable to conclude that some dealers will be forced out of business by the regulations, yes."

Perhaps the toughest regulation issued by the CFTC — the one Rainbolt labeled the "gut" of all of them — is the one calling for segregation of customer funds.

The account segregation rule would require dealers to keep customer option accounts individually and also to hold the funds in the United States until the purchased option has either been sold or has expired. Since the dealers must purchase the options from brokers on the London exchanges, this means that the US dealers would have to buy them with their own funds, a procedure that would require either plenty of cash on hand or, more likely, an extensive line of credit at a bank.

A newly formed organization of commodity option dealers recently sent representatives to London in an effort to convince the exchanges there that they should urge the CFTC to abandon the account segregation rule or else greatly modify it. The CFTC is accepting modification proposals up till Nov. 8.

Rainbolt said the commission already has rejected one proposal from the exchanges, but he declined to disclose the details. A revised proposal from the London exchange is expected shortly, he added.

Rainbolt, however, says the London exchange proposals aren't based on the appeals of the US commodity option dealers.

"I feel they resent the pressure they've been getting from the dealers . . . . The way I see it the London Commodity Exchange, the International Commodity Clearing House and the Bank of England, the three parties involved over there, have a mutuality of interest with the CFTC to clean up the bad reputation of options in the United States. But both of us want to do it without throwing the baby out with the bath water."

Rainbolt and other CFTC officials are not convinced that there isn't a place for commodity option trading in this country, including the now banned trading on domestic exchanges. While recognizing the wholesale abuses in commodity option trading that has resulted from the regulatory vacuum, Rainbolt believes that with proper supervision options in commodities might serve a useful economic purpose.

"Just about all of the big reputable brokerage houses have stayed out of this business because of the problems," he notes. "With the right rules that wouldn't be the case."

Sure – the rules will give them our business!

EXHIBIT TO AFFIDAVIT OF JAMES CARR

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CFTC ADOPTS INTERIM COMMODITY OPTIONS REGULATIONS

WASH--SEP 29--CNS--THE COMMODITY FUTURES TRADING COMMISSION HAS APPROVED INTERIM RULES REGARDING COMMODITY OPTIONS TRADING THAT, AMONG OTHER THINGS, WOULD REQUIRE THAT ALL CUSTOMER MONIES BE SEGREGATED IN THE U.S. UNTIL THE OPTION IS EXERCISED OR LAPSES.

THE NEW REGULATIONS ARE TO BECOME EFFECTIVE ABOUT NOV 18 OR 45 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER, EXPECTED OCT 4. THE REGULATIONS ARE INTERIM MEASURES TO PROVIDE BETTER CUSTOMER PROTECTION WHILE THE CFTC DRAFTS ITS FINAL REGULATIONS FOR A THREE-YEAR PILOT OPTIONS TRADING PROGRAM.

IN ADDITION TO REQUIRING SEGREGATION OF FUNDS IN THE U.S., THE NEW REGULATIONS WILL:

--REQUIRE ALL PERSONS OFFERING OPTIONS TO THE PUBLIC TO REGISTER WITH THE CFTC AS FUTURES COMMISSION MERCHANTS (FCMS) AND THEIR EMPLOYERS AS ASSOCIATED PERSONS WITHIN 90 DAYS.

--REQUIRE FCMS ENGAGED IN THE OPTIONS BUSINESS TO MEET A 50,000 DLR MINIMUM CAPITAL REQUIREMENT.

--REQUIRE PERSONS SOLICITING OR ACCEPTING ORDERS FOR COMMODITY OPTIONS TO MAKE A SUMMARY DISCLOSURE PRIOR TO THE SELLING OF THE OPTION OF ALL FEES, CHARGES TO BE PAID, PREMIUMS, MARK-UPS ON PREMIUMS AND SALES COMMISSION AND OF THE RISKS INVOLVED.

--REQUIRE BOOKS AND RECORDS TO BE KEPT AND BE MADE AVAILABLE FOR INSPECTION.

THE CFTC SAID TODAY IT PLANS TO REPLACE THE INTERIM REGULATIONS WITH MORE PERMANENT REGULATIONS IN ABOUT 90 DAYS. THOSE NEW REGULATIONS FOR A LIMITED THREE-YEAR PILOT PROGRAM OF COMMODITY OPTIONS TRADING ON DOMESTIC EXCHANGES AND RECOGNIZED FOREIGN MARKETS WILL BE FORMALLY PROPOSED IN ABOUT A MONTH, THE CFTC SAID.

IN DISCUSSING THE INTERIM REGULATIONS YESTERDAY, THE COMMISSIONERS ACKNOWLEDGED THAT IN THE CASE OF FOREIGN OPTIONS THE INTERIM SEGREGATION REQUIREMENT WILL RESULT IN DOUBLE AND PERHAPS EVEN TRIPLE SEGREGATION, BE A HARDSHIP ON THOSE SELLING FOREIGN OPTIONS IN THE U.S. AND MIGHT EVEN PUT MARGINAL OPTIONS DEALERS OUT OF BUSINESS

THE COMMISSION DETERMINED, HOWEVER, THAT CUSTOMER PRO CTION
ONSIDERATIONS WARRANTED THE ACTION AND THAT SUCCESSFUL, LEGITIMATE
PTIONS DELAERS PROBABLY COULD CARRY THE BURDEN OF THE ADDED OPER-
TING COSTS THROUGH FINANCIAL LOANS FOR THE SHORT PERIOD INFOLVED.
. THE CFTC ASKED FOR COMMENT ON ITS PROPOSED REGULATIONS, AND INDICA-
ED IT MAY RECONSIDER THE SEGREGATION REQUIREMENT IF SUITABLE
EQUIVALENT CUSTOMER PROTECTION PLANS ARE PRODUCED. THEY EXPRESSED
SKEPTICISM THAT SUCH PLANS WILL BE FORTHCOMING IN TIME.
THE COMMISSION INDICATED IT MAY CONSIDER ALTERNATE CUSTOMER
PROTECTION PLANS AFTER GERALD FISHMAN, AN ATTORNEY REPRESENTING
ROSENTHAL AND CO, PUT FORTH SOME POSSIBLE ALTERNATIVES.
ACKNOWLEDGING THAT THERE HAS NOT BEEN SUFFICIENT TIME "TO
RESEARCH WHETHER ANY OF THESE PROPOSED ALTERNATIVES ARE VIABLE OR
PRACTICAL IN THE BUSINESS WORLD," FISHMAN SAID ROSENTHAL FELT THEY
NEEDED TO BE PUT FORWARD BECAUSE THE SEGREGATION REQUIREMENT
ADOPTED BY THE COMMISSION, ROSENTHAL BELIEVES, WOULD RESULT IN THE
BANNING OF THE SALE OF LONDON OPTIONS IN THE U.S. BY BOTH BIG AND
SMALL OPERATORS.
THE POSSIBLE ALTERNATIVES ROSENTHAL SUGGESTED ARE:
--AN EXEMPTION FROM DOUBLE SEGREGATION REQUIREMENTS WITH RESPECT
TO CLEARING MEMBERS OF THE INTERNATIONAL COMMODITIES CLEARINGHOUSE
(ICCH) IN LONDON WHO MAKE PREMIUM DEPOSITS WITH THE ICCH.
--THE POSTING OF A SURETY BOND BY THE FCM IN THE U.S. TO COVER
POTENTIAL DEFAULTS;

CREDIT ON AN IRREVOCABLE

--THE SECURING BY THE FCM OF LETTERS OF CREDIT ON AN IRREVOCABLE
ASIS COVERING CUSTOMERS' FUNDS IN THE EVENT OF DEFAULT BY EITHER
HE GRANTOR OF THE OPTIONS OR THE FCM;
--CORRESPONDING CREDIT ARRANGEMENT BETWEEN ENGLISH AND U.S.
ANKS FOR THE BENEFIT OF FCM CUSTOMERS;
--AND THE POSSIBILITY OF SECURING GUARANTEES OR "COVER" FROM THE
XPORT CONTROL GURANTEE DEPARTMENT OF THE BRITISH GOVERNMENT.
FISHMAN TOLD THE COMMISSION ROSENTHAL HAS HAD PRRELIMINARY
ISCUSSIONS WITH ICCH MANAGEMENT AND THAT ROSENTHAL IS INFORMED THAT
ICCH WOULD BE WILLING TO EXPLORE THE POSSIBILITY OF SETTING UP A
EGREGATED TRUST FUNDS ACCOUNT FOR THE BENEFIT OF OUR CLIENT'S
USTOMERS." END

AFFIDAVIT OF JOHN FORMA IN SUPPORT OF TEMPORARY RESTRAINING ORDER

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP.
and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the
COMMODITY FUTURES TRADING COMMISSION;
JOHN V. RAINBOLT III, Vice Chairman of
the COMMODITY FUTURES TRADING COMMISSION;
READ P. DUNN, GARY SEEVERS, and ROBERT
L. MARTIN, Commissioners of the COMMODITY
FUTURES TRADING COMMISSION,

Defendants.

AFFIDAVIT OF JOHN FORMA
IN SUPPORT OF A TEMPORARY RESTRAINING ORDER
AND PRELIMINARY INJUNCTION

State of New York)
) SS.:
County of New York)

JOHN FORMA, being duly sworn, deposes and says:

1. I am the President of British American Commodity Options Corp. ("British American"), one of the plaintiffs herein and submit this affidavit in support of a temporary restraining order and preliminary injunction, as well as declaratory relief, to temporarily and permanently enjoin the Commodity Futures Trading Commission from implementing and enforcing the proposed regulations relating to commodity options first published in the Federal Register on October 8, 1976 and which as to substantially all of the provisions, go into effect on November 22, 1976.

2. Prior to the publication of these "proposed" regulations, all of the published proposals of the CFTC did not in

any way indicate that the Commission would do an about-face and "propose" new regulations designed to put not only British American but all of the other existing retailers of London commodity options summarily out of business.

3. Attached hereto as Exhibit "A" are the original proposed regulation of commodity option transactions first published in the Federal Register on February 20, 1976. Not only did our counsel participate in the public hearings in Washington on March 8, 1976, but at the request of the panel submitted his comments in writings subsequent thereto, a copy of which is annexed hereto as Exhibit "B".

4. The next important event was that on or about July 15, 1976, the report of the Advisory Committee on the Definition and Regulation on Market Instruments to the Commodity Futures Trading Commission issued its recommended policies on commodity option transactions, a copy of which is annexed hereto as Exhibit "C". In this connection it should be noted that many of the recommendations made by our counsel back in March were incorporated into these recommended policies of the Advisory Committee. Thereafter, on approximately August 20, 1976, the Advisory Committee on commodity futures trading professionals rendered its report to the Commodity Futures Trading Commission, a copy of which is annexed hereto as Exhibit "D".

5. The next and most crucial publication was the Commission's "proposed" regulations first published in the Federal Register on October 8, 1976. Our counsel was directed to furnish comments to these "proposed" regulations and attached

hereto as Exhibit "E" is a copy of our counsel's comment letter which sets forth in detail our specific comments with respect to these "proposed" regulations. Rather than recapitulate or attempt to summarize this lengthy comment letter, reference is made to that comment letter which shows that these "proposed" regulations bear no relation to reality and are clearly improper, abritrary, capricious, an abuse of discretion, and beyond the scope of the enabling legislation to the recent amendments to the Commodity Exchange Act. Even worse, they are clearly anti-competitive in direct contravention of ¶19 of the Commodity Exchange Act of 1974, as amended, which requires that not only must the Commission consider in its rulemaking process competitive factors, but it is required to adopt the least anti-competitive measures.

6. Under the regulatory environment existing prior to October 8, 1976, British American was probably the leading company in creating the viability of the London commodity options as a meaningful investment vehicle for the general public in the United States.

7. During the past year, British American has built up a very substantial business with a net worth of close to one million dollars, over 200 employees, and over 2500 customers much to the embarrassment of the CFTC and the established securities broker-dealers who were unwilling to risk their capital to develop this business. To now eliminate the existing retail dealers and permit these companies, which have blissfully sat on the sidelines awaiting the opportunity, which opportunity

the CFTC is openly assisting them in, to take over our customers and our good will at no cost, is obviously unjust and unfair.

8. Attached as Exhibits to the affidavit of James Carr is a representative sampling of the vicious and false and misleading press campaign which the CFTC has instituted to support its attempt to rush these regulations through without the appropriate consideration.

9. The CFTC well knows from their own inspection of British American's books and record that our customers have done extremely well and as of the date of the administrative proceeding, instituted by that agency against us to deny our registration application, over 92% of our customers whose options expired or who elected to sell had substantial profits, 5% broke even, and 2% lost money. When the CFTC began to realize that they were beginning to lose in the administrative proceeding, they then went into federal court and attempted to put British American out of business until the conclusion of the administrative proceeding.

10. In that case, which is entitled Commodity Futures Trading Commission v. British American Commodity Options Corp., in the United States District Court for the Southern District of New York (76 Civ 3247), not only was the Commission's request for a preliminary injunction denied by way of a directed verdict at the close of the plaintiff's case, but the court specifically found that there was no evidence that British American was

mistreating or misleading its customers or the general public and that it was engaged in legitimate business activities. Since this is the only litigated case to deponent's knowledge, it is quite amusing that the Commission in its press campaign has characterized all of the companies as "boiler-room operations" which should be put out of business without the benefit of any judicial process. This is a democracy and not a police state, and deponent just cannot believe that the courts will permit the agency to arbitrarily and indiscriminately enjoin an industry with a net worth of many millions of dollars, thousands upon thousands of customers who have done well on an indiscriminate and arbitrary basis because that agency has not discharged the very function for which it was created, the implementation of a rational regulatory scheme for the protection of the general public and to encourage investing in commodities and commodity options.

11. No wonder E. F. Hutton recently announced with the CFTC that they are willing to now enter the business if the proposed regulations are adopted in their present context! At no cost to them, they will be able to pick up all of our business which has cost British American over $20 million in the last year consisting of substantial expenses for salesmen's commissions, marketing, general overheard and back office. Not only will they pick up our customers at no cost, but they will have picked up the benefit of our back office procedures, substantially all of which were incorporated in these proposed regulations at no cost.

12. The CFTC's most recent tactic, as reflected by these "proposed" regulations, should be called the great commodities robbery of the 1970s.

13. As these regulations are presently worded, British American has two choices. The first choice is to immediately close our doors and tell our 200 employees that they must seek employment elsewhere, tell our 2500 customers that they must go to another brokerage house to close out their options at a substatial cost to the customer since we do not charge for the closing out of commodity options transactions and leave this business for a few selected large brokerage firms which are in league with the Commodity Futures Trading Commission.

The second alternative is to openly defy these regulations after November 22, 1976 and would subject British American and its employees to potentially serious civil and criminal liability.

14. At the public hearing on March 8, 1976, it became readily apparent that the CFTC had absolutely no understanding about London commodity options and since that date both the company and its counsel have offered to the staff of the Commodity Futures Trading Commission its services in formulating meaningful regulations for this industry. Unfortunately, for this industry and the general public, the staff of the CFTC has ignored these offers and the result is self-evident in the "proposed" regulations set forth in the Federal Register dated October 8, 1976.

WHEREFORE, the undersigned respectfully requests that this

Court temporarily restrain and subsequently preliminarily enjoin the CFTC from implementing and enforcing the "proposed" regulations, which automatically become effective as to all of the provisions except the registration provisions on November 22, 1976.

John Forma
President, British American
Commodity Options Corp.

Sworn to before me this
15th day of November, 1976.

Notary Public

EXHIBIT "A" TO AFFIDAVIT OF JOHN FORMA

COMMODITY FUTURES TRADING COMMISSION

[17 CFR Part 32]

REGULATION OF COMMODITY OPTION TRANSACTIONS REGISTRATION; FRAUD

Notice of Proposed Rulemaking

The Commodity Futures Trading Commission (the "Commission") has decided that the public interest requires that it put into effect regulations under Section 4c(b) of the Commodity Exchange Act (the "Act"), as added by Section 402 of the Commodity Futures Trading Commission Act of 1974 ("CFTC Act"), 7 U.S.C. § 6c(b), relating to commodity options. The Commission is cognizant of the fact that transactions in the commodity option area have been, are, and continue to be, entered into without there being in effect comprehensive and substantive regulations to protect the public from abuses or potential abuses.[1] Accordingly, the Commission is publishing for comment the regulations which accompany this FEDERAL REGISTER notice.

The Commission wishes to stress, at the outset, two salient points:

First, the Commission expects to receive recommendations from its Advisory Committee on the Definition and Regulation of Market Instruments by no later than March 30, 1976. After the Commission has had an opportunity initially to evaluate those recommendations and the oral and written comments it receives on the proposed rules, the Commission will determine whether it will require additional time to study the recommendations and comments in order to evaluate the extent to which they should be included as part of a permanent regulatory program. If the Commission believes that such additional time is required, the proposed rules may be adopted as interim and temporary rules only. Commentators should also be aware that although the proposed regulations relate to transactions which are not entered into on a contract market, the Commission is affirmatively considering permitting commodity option transactions to be traded on or subject to the rules of a contract market which have been approved by the Commission as adequate to effectuate the purposes of the Act. The Commission would particularly welcome comments on what standards (differing from or similar to those proposed) should be applied if such transactions are so traded under the protections of a clearing association of a contract market. Trading on contract markets is a distinct possibility; two contract markets have already applied for designation to trade commodity options. Ultimately, the Commission may adopt regulations which restrict commodity option transactions to trading on contract markets.

Second, the comment period with respect to these proposed rules will extend to March 31, 1976, and, although not required, the Commission has determined to hold an oral hearing on March 8th and 9th to permit additional presentations and comment on the matter. Allowing for a period to evaluate both the oral and written comments and the recommendations of its Advisory Committee, it is expected that the regulations, as appropriately modified, will be promulgated on or before April 15, 1976. The Commission has determined that it is in the public interest that regulations be put into effect in the shortest possible time in light of the fact that the Commission believes a situation exists requiring definitive public protection. By the procedure proposed, the Commission will have afforded all interested parties [illegible] fullest opportunity to provide meanin[illegible] comment, whether oral or written, consistent with its obligation to have definitive regulations in place in the shortest possible time. The Commission urges all affected parties to begin now to compile the necessary information and data required to apply for registration under the proposed rules. The Commission believes that the processing of applications will take 30–45 days at a minimum. The Commission will act on applications in the order in which they are filed, and wishes to remind prospective registrants that if the regulations are adopted as proposed, the net working capital rule [see Section 32.2(a)] will go into effect on April 15, 1976, and, more significantly in this context, it will be unlawful from and after May 28, 1976, for transactions to be offered or entered into by a commodity option dealer unless such person is registered with the Commission. The registration process takes time and, accordingly, prospective registrants should take the necessary steps to file their applications as soon as possible. If the Commission is unable to complete the processing of an application by May 28, 1976, it may, under the exemptive provisions of the proposed rules, grant (on request or on its own motion) a temporary exemption from registration until processing is completed. However, no such exemptions will be granted for those whose applications are not filed in time to enable the Commission to conduct at least a preliminary review of the application well in advance of May 28, 1976.

Prior Proposal. On October 22, 1975, the Commission announced that it was considering the adoption of rules to regulate—or perhaps forbid—transactions in commodity options, including the promulgation of a temporary rule pending the adoption of a definitive regulatory program. 40 FR 49360. Section 4c(a)(B) of the Act expressly prohibits option transactions relating to those commodities which were regulated under that Act prior to the enactment of the CFTC Act.[2] As amended by the CFTC Act, Section 2(a)(1) of the Act, 7 U.S.C. § 2, expended the definition of commodity to include "all other goods and articles * * * and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in. * * *" With respect to these newly-regulated commodities, Section 4(b) of the Act provides that no person shall offer to enter into, enter into, or confirm the execution of, any commodity option transaction contrary to any rule, regulation or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe.

At the time of its announcement concerning commodity option transactions, the Commission solicited the views of interested persons concerning whether one or another of several regulatory approaches discussed in the announcement—or some other approach—should be adopted, and stated also that it had assigned to its Advisory Committee on Definition and Regulation of Market Instruments the responsibility to consider and report its reco[illegible]tions to the Commission on appropriate regulation of commodity options.

The Commission has considered all of the comments and suggestions which it has received on the various regulatory approaches for regulating commodity option transactions and has decided to publish for comment the rules proposed herewith.

Exclusive Jurisdiction. The Commission again points out that Section 2(a)(1) of the Act, as amended, 7 U.S.C. § 2, provides that the Commission shall have "exclusive jurisdiction" with respect to "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' * * *, and transactions involving contracts of sale of a commodity for future delivery. * * *" And, as noted above, no person may offer to enter into, enter into, or confirm the execution of any commodity option transaction contrary to the Commission's rules. The proposed rules announced today are to be effectuated pursuant to the exclusive jurisdiction of the Commission and under the authority contained in Section 4c(b) of the Act.

Least Anticompetitive Means. In proposing the regulations hereinafter set forth, the Commission has, in accordance with Section 15 of the Act, 7 U.S.C. section 19, taken into consideration the public interest to be protected by the antitrust laws. While it recognizes that the significant financial and other criteria imposed as prerequisites to allowing a person to enter into or continue in business as a commodity option dealer may result in some lessening of competition, the Commission believes that the proposed rules are a necessary minimum for effectuating the purposes and policies of the Act which require that the Commis-

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[1] The Commission has adopted broad anti-fraud rules in the commodity option area. See 17 C.F.R. § 30.01. The Commission believes, however, that a comprehensive regulatory program is necessary to carry out its responsibilities under the Act and, in this way, effectuate the remedial purposes of the statute.

[2] Prior to the effective date of the CFTC Act, the Act provided for the regulation of * * * wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain, sorghums, millfeeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. * * *

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sion assure the financial solvency of option transactions and prevent fraud or manipulation. The Commission has determined that minimum financial and other requirements are essential to public protection under the Act. Accordingly, the Commission believes that, in imposing the minimum financial requirements and the other requirements of the proposed regulations, it has taken the least anticompetitive means of achieving the objectives, policies and purposes of the Act.

Scope of the Rules. The proposed rules concerning commodity option transactions are to be adopted as a new Part 32 of Title 17 of the Code of Federal Regulations.

The proposed rules basically make it unlawful for any commodity option dealer, as defined in § 32.1, to offer to enter into, enter into or confirm the execution of any transaction subject to the proposed rules unless (1) on and after April 15, 1976, the dealer has at all times total assets in excess of total liabilities and maintains at all times net working capital, as computed in accordance with Section 32.10 in excess of $100,000 and (2) on and after May 28, 1976, the commodity option dealer is registered as such with the Commission. Also, the proposed rules require a dealer, on and after May 28, 1976, in connection with offers to enter into commodity option transactions, to inform each prospective purchaser that the dealer has filed an application in connection with its registration with the Commission containing information about the dealer, the dealer's business and its financial condition and that copies of such filings are available for public inspection at all offices of the dealer and at the Commission's offices in Washington, D.C.

Since the information required under the proposed rules is rather extensive, the Commission has determined that it would be appropriate to afford commodity option dealers additional time to prepare and submit some of the information required by the proposed rule by filing such information as amendments to the initial application. The Commission points out that proposed rules do not require that a commodity option dealer deliver any form of disclosure document to prospective purchasers in advance of any purchase. The Commission would particularly welcome comments on whether such a requirement should be imposed on commodity option dealers (presently dealing off contract markets) and whether such disclosure documents are or should be applicable to commodity option transactions.

The Commission wishes to advise affected persons under the proposed rules that the regulation contained in 17 CFR § 1.19, which prohibits futures commission merchants from assuming financial responsibility for a commodity option transaction, would be revoked as of April 15, 1976. In view of the financial and other standards to be established by the proposed rules regarding commodity option transactions, the Commission believes there is no reason why a futures commission merchant should not be permitted to assume financial responsibility for commodity option transactions should it be able to meet those standards.

Set forth below is a synopsis of the proposed rules, together with a discussion of certain of the factors considered by the Commission in proposing the rules and of the comments which the Commission is particularly interested in receiving in connection with its proposals.

DEFINITIONS

[NOTE: Certain of the terms used in the proposed rules are already defined in the Commission's general regulations contained in Chapter I of 17 CFR].

Section 32.1 of the proposed rules defines certain terms used in the proposed rules. The term "purchaser" is defined in § 32.1(a) to mean any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option transaction from any commodity option dealer. Section 32.1(b) defines a "commodity option transaction" as any transaction which the Commission is authorized to regulate under section 4c(b) of the Act.[2] Section 32.1(c) defines a "commodity option dealer" and "dealer" to mean any person engaged in the business of offering to enter into, entering into, or confirming the execution of, commodity option transactions, whether or not that person makes, underwrites, issues or otherwise assumes any financial responsibility for any commodity option transaction. Under this definition, a person who acts solely as an agent in connection with an option transaction is nevertheless a dealer for purposes of the proposed rule.

Section 31.2(d) defines an "affiliated person" to mean, with certain limited exceptions, any general partner, officer, director, manager, salesperson or employee of a person, or any person occupying a similar status or performing similar functions (such as, for example, an independent sales representative), or any person controlling or controlled by another person. These terms are employed in later sections of the proposed rules, such as in the section providing that each application filed by a commodity option dealer disclose certain information about the dealer and each affiliated person of a dealer. Section 32.1(f) contains a broad definition of "promotional material" used by a dealer in connection with the offer of commodity option transactions. Copies of all promotional material must be included in the original application for registration of a commodity option dealer. In addition, § 32.1(g) defines "premium" to mean the charge to a purchaser for entering into a commodity option transaction.

UNLAWFUL TRANSACTIONS

The Commission thoroughly considered whether it should impose financial standards on persons offering commodity option transactions. As previously noted, the Commission has determined that such financial standards would help to assure the financial solvency of these transactions and, accordingly, § 32.2(a)(1) of the proposed rules provides that from and after April 15, 1976, it shall be unlawful for a commodity option dealer to offer or sell commodity option transactions unless it maintains at all times a net working capital in excess of $100,000 and unless at all times its total assets exceed its total liabilities. Net working capital must be computed in accordance with § 32.10(b) of the proposed rules. In this regard, the Commission wishes to emphasize that in computing net working capital under the proposed rules there must be excluded from current assets (1) all premiums charged to any purchaser and (2) all assets which are not located within the territorial limits of the United States.

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[2] The statute refers to any "transaction * * * which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty'. * * *" Section 4(c)(b), 7 U.S.C. 6c(b). For convenience in this release, the Commission is utilizing the term "option" to include all transactions described by this provision.

In addition to the financial requirements imposed by § 32.2(a) of the proposed rules, §§ 32.2(b) and (c) basically provide that from and after May 28, 1976, it shall be unlawful to offer or sell commodity option transactions unless the dealer is registered with the Commission and informs prospective purchasers that the dealer has filed with the Commission an application for registration and any amendments thereto, disclosing information concerning the dealer, its personnel, financial condition and business operations and that such filings are available for public inspection during normal business hours at all offices of the dealer and at the offices of the Commission in Washington, D.C. In order to permit sufficient time for persons to apply for registration, the date upon which all commodity option dealers must be registered and comply with the other requirements of § 32.2(b) has been fixed approximately six weeks after the financial standards imposed by the proposed rules are to become effective.

Futures commission merchants which engage in business as a commodity option dealer will be required to maintain net working capital in accordance with § 32.2(a) and, insofar as their futures commission merchant business is concerned, will also continue to be required to maintain and compute adjusted net working capital separately in accordance with 17 CFR § 1.17.

The Commission recognizes that the $100,000 net working capital requirement may be inappropriate for certain commodity option dealers who act solely on an agency basis for other dealers who issue or assume full financial responsibility for the commodity option transaction. Accordingly, the Commission wishes to advise such dealers that pursuant to the exemptive provisions contained in § 32.3(b) of the proposed rule, the Commission will entertain requests for an exemption from the net working capital requirement accompanied by a written statement of the underwriter of the option transaction, with supporting documentation, which establishes that the dealer is acting solely as an agent for an underwriting commodity option dealer who is or will be registered under the proposed rule, who has assets located within the United States, and who is ultimately fully responsible for the commodity option transaction of the dealer applying for the exemption. The Commission anticipates that, in most cases, any exemptions granted will nevertheless require the maintenance by the agent dealer of some minimum net working capital, although in a reduced amount.

The Commission is cognizant that the proposed rules do not require a commodity option dealer to segregate premiums from its assets or to deliver a disclosure statement to prospective purchasers. With respect to segregation of premiums, while the Commission has determined not to impose such a requirement on commodity option dealers because of inherent difficulties of ascertaining which dealer should segregate (i.e., the problem of double segregation), it is particularly interested in receiving comments as to whether such a requirement should and could be imposed. With respect to the delivery in advance of disclosure statements to prospective purchasers, as noted previously, the Commission is also interested in the views of interested parties as to whether such a requirement should be imposed.

EXEMPTIONS

Several commentators suggested that no public interest would be served by regulatory provisions governing commercial commodity option transactions with certain users, producers or consumers. The Commission has considered these comments and has concluded that there may be no substantial public interest to be served by requiring the registration of dealers who engage exclusively in such commercial-type transactions and that it appears that application of the Commission's antifraud rule governing commodity option transactions achieves the full regulatory objective in that case. In addition, the Commission believes that the burdens associated with registration should not be required in connection with the occasional offer or sale of commodity option transactions. Accordingly, the Commission has determined to exempt from the operation of the proposed rules the offer and sale of commodity option transactions to the purchasers referred to in § 32.3(a)(1) of the proposed rules. Of course, to the extent that a dealer offers or sells commodity option transactions to persons other than, or in addition to, such purchasers, compliance with the proposed rules would be required, unless the exemption afforded by section 32.3(a)(2) is available. Under this section the offer or sale to less than 10 persons (in addition to the purchasers referred to in paragraphs (a)(1) of the section) during any period of 12 consecutive months will be exempt from the operation of the proposed rules. This section also contains a provision as to how the number of persons is to be computed for purposes of the exemption. Section 32.3(b) provides that the Commission may by order, upon request or its own motion, exempt from the provisions of the proposed rules any person, either unconditionally or on a temporary or other conditional basis, if it finds that such exemption would not be contrary to the public interest. Among other things, this section would provide the basis upon which a dealer acting solely as agent in connection with option transactions could secure a lowering of the $100,000 net working capital requirements in the proposed rules.

The Commission intends to monitor closely the effect the exemptions in section 32.3(a) have in the marketplace to ascertain whether they are necessary or appropriate. The Commission would welcome comments as to whether these exemptions are, or any additional exemptions would be, in the public interest. The Commission wishes to emphasize that the exemptive provisions expressly do not exclude any dealer from the proscriptions in the Commission's general antifraud rule governing commodity option transactions presently in effect, which is to be re-codified as section 32.13 of the proposed rules. This antifraud rule applies and will continue to apply to all offers and sales of commodity option transactions subject to Commission regulation whether or not these transactions are subject to or exempt from any provisions of the proposed rules.[•]

APPLICATIONS FOR REGISTRATION

Section 32.4 of the proposed rules concerns the procedures to be followed in filing an application for registration as a commodity option dealer. This section requires that an applicant for registration file an original and four copies of the application with the Commission. Also, at the time of filing an application with the Commission, the applicant must also submit one copy to the official administering the state securities laws in each state in which the applicant is offering and proposes to offer commodity option transactions or to such other state official as such official may designate in writing to the Commission. The Commission will specify by public notice any such

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[•] In this connection, the Commission considers that it is a violation of its antifraud rules governing these transactions for a person to deceive a purchaser or prospective purchaser by any means whatsoever concerning, among other things, the past business history of a person, the action of the Commission with respect to any such transaction, the risks, safety, understandability or profitability of any such transaction, the segregation of customers' funds or property, financial resources or financial condition of a person, the effect of offering or selling such transactions at a "discount" or "bargain" price, and the effect of soliciting and pressuring purchasers to "roll over" their transactions and enter into new transactions at substantial discount prices. *See* Commodity Futures Trading Commission v. American Options Corp. *et al.*, CCH Com. Fut. Law. Rep. ¶20,107 (C.D. Cal. 1975).

designated official and his location. By this latter procedure, the Commission believes that the regulatory authorities in each state will have the opportunity to express their views concerning the commodity option dealer's operations and the Commission thereby will be able to obtain the benefit of their views as to how best to prevent or remedy abuses in the offer and sale of commodity options. The Commission is particularly interested in obtaining information from state authorities concerning violations of the proposed rules, including the Commission's general antifraud rule, and in coordinating enforcement actions arising out of such violations.

The filing of an application must be accompanied by a registration fee of $750.00. A renewal registration fee will also be required under the provisions of the proposed rules relating to the effectiveness of registration. These registration fees are designed to permit the Government to recover basically the costs associated with the Commission's review of applications and other filings concerning the operations and financial condition of those commodity option dealers who apply for registration with the Commission.

Bearing the public interest in mind, it is important that applicants for registration be aware of their responsibility to file complete and accurate information with the Commission. Accordingly, under § 32.4(c) of the proposed rules, the original of the application filed with the Commission must be filed with a cover page signed by or on behalf of the applicant, which must contain (1) a statement that the application is filed pursuant to Section 4c(b) of the Act and Part 32 of 17 CFR; (2) a certification by the applicant that all statements contained in the application are true and correct; and (3) if the applicant is a corporation or other entity that transacts business through a management group similar to a board of directors, that the filing of the application and its contents have been authorized by the applicant's board of directors or applicable management group. Furthermore, the proposed rules in section 32.6 provide generally that any false or misleading statement of a material fact or the omission of a material fact in an application, amendment thereto or in any report required to be filed with the Commission, shall constitute cause for the denial, suspension or revocation of the registration of a commodity option dealer.

CONTENTS OF APPLICATION

Section 32.5 of the proposed rule sets forth the information which must be contained in the application for registration of a commodity option dealer. A commodity option dealer is also required, pursuant to §§ 32.8 and 32.9 of the proposed rule, to file amendments to the application, containing additional information concerning the dealer's business operations and financial condition, within 30 and 60 days respectively, of the filing of the original application.

The specific information to be disclosed by a dealer under section 32.5 concerns the identity of the dealer and details of the background of the dealer and its affiliated persons. Required disclosure includes the name under which the commodity option dealer is doing or intends to do business; the addresses and telephone numbers for the dealer's principal business office and all branch offices; names of principal and branch-office managers; duly completed CEA Forms 94 (biographical information) for the dealer and all affiliated persons of the dealer and for all persons owning 10% or more of the equity or other ownership interest in the dealer; a description of any specified proceedings instituted against the dealer; a list of the states in which the dealer is offering and proposes to offer any commodity option transaction; the name and address of agents authorized to receive notices and service of legal process at its principal office and in each state; complete factual details of the existence of specified events relating to the dealer or any affiliated person, such as certain convictions, injunctions, suspensions, violations and proceedings; and the filing of copies of all promotional material. Copies of CEA Form 94 may be obtained from the Commission's Regional Offices and by its Bureau of Registration and Audit in Washington, D.C.

In addition, the application of the dealer must include, if available, a balance sheet of the dealer audited by an independent certified public accountant as of the end of the dealer's most recent fiscal year unless such fiscal year has ended within 90 days prior to the date of the filing of the application in which case the balance sheet may be as of the end of the preceding fiscal year, or if no audited balance sheet is available, then an unaudited balance sheet as of the end of the most recent fiscal year. There is also to be included a statement setting forth the computation of the net working capital of the dealer as at the date of the balance sheet filed, which statement must be audited if the accompanying balance sheet is audited. Should the person applying for registration as a commodity option dealer be registered with the Commission as a futures commission merchant, the application may omit certain of the information otherwise required (since such information is already on file with the Commission) but shall contain a statement that such person is so registered as a futures commission merchant and the effective date of such registration.

EFFECTIVENESS OF REGISTRATION

Under § 32.6(a), the Commission shall declare effective the registration of a commodity option dealer if it appears that the requirements of the proposed rules have been satisfied. Under (b), section the Commission may, after notice and opportunity for hearing, deny the registration if it finds that the dealer is unfit to engage in business as a commodity option dealer (1) because the dealer, whether prior or subsequent to becoming such, or any affiliated person of the dealer, whether prior or subsequent to becoming so affiliated, has failed to comply with any of the provisions of the proposed rules; has made or caused to be made in any application for registration, amendment thereto, or report required to be filed with the Commission, any false or misleading statement of a material fact, or has omitted to state therein any material fact which is required to be stated therein; has engaged in any practice of the character prohibited by the Act; or has engaged or is engaging in operations which threaten the financial solvency of any commodity option transaction or tends to permit manipulation or fraud in or in connection with any offer to enter into, entry into or confirmation of the execution of any commodity option transaction; or (2) for other good cause shown. The grounds for denial of registration essentially are those set forth under section 8a(2) of the Act, 7 U.S.C. 12a(2), including the "good cause shown" standard. As indicated in the proposed rules, the "good cause shown" standard will include, the occurrence of any of the events specified in § 32.5(a)(7) of the proposed rules and will also include those grounds for denial of registration of other persons required to register under the Act with the Commission as announced by the Commission in its interpretation of that term on July 3, 1975.[3] In making that announcement, the Commission stated that its interpretation was illustrative—not inclusive—of the grounds for denial and was not meant to be an exhaustive listing of the causes or grounds for denial of registration. The same consideration will apply to the "good cause shown" standard contained in the proposed rules.

Section 32.6(b) also provides that the Commission may, after notice and opportunity for hearing, suspend or revoke the registration of the commodity option dealer, if cause exists which would warrant a denial of registration. Section 32.6(c) of the proposed rules provides that all registrations expire one year from the date that registration becomes effective and may be renewed upon application, subject to the same requirements as in the case of an initial application. All registrations granted under the proposed rules, however, will terminate on the effective date the Commission revokes or supersedes the provisions of the rules. Since the Commission may adopt the proposed rules on an interim basis, registrants should be aware that regulatory requirements may change substantially at such time as permanent regulations are adopted.

The Commission has previously expressed the view that generally persons who are offering commodity options to the public should register with the Commission as commodity trading advisors as defined in section 2(a)(1) of the Act, 7 U.S.C. section 2.[4] In view of the fact that the proposed rules require commodity option dealers to register with the Commission, the Commission has determined that the registration of such persons as commodity trading advisors would serve no additional public interest. Accordingly, section 32.6(d) of the proposed rules basically provides that a commodity option dealer is not included in the term commodity trading advisor if such person is duly registered with the Commission as a commodity option dealer and the furnishing of the services which would constitute a person as a commodity trading advisor is solely incidental to the dealer's business. Those persons who have registered or applied for registration with the Commission as commodity trading advisors solely because of their offering of commodity options to the public need not renew their registrations which will expire on July 30, 1976, or may voluntarily withdraw their applications, as the case may be. Of course, all such persons must register with the Commission under the rules proposed herein.

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[3] See 40 FR 28125 (July 3, 1975).

[4] See 40 FR 49361, n. 11 (October 22, 1975).

Amendments to Applications

Section 32.7 of the proposed rules provides that if any information contained in any application for registration as a commodity option dealer, or in any amendment thereto, has become incomplete or inaccurate in any material respect, the commodity option dealer, shall, not later than 30 days after such occurrence, file an amendment to the application correcting or supplementing the information it contains. Notwithstanding the 30-day provision, of course, commodity options may not be sold or offered on the basis of materially misleading or untrue statements since such activity is prohibited under the Commission's general antifraud rule governing these transactions. Accordingly, amendments involving material information required to be disclosed should be filed promptly. Any such amendment must be filed and submitted in the manner and form as prescribed for an application originally filed.

Business Operations Report

Section 32.8 of the proposed rules requires that within 30 days after the filing of an application for registration, the dealer must file an amendment to the application containing a detailed report in narrative form of the nature of, and the manner in which, the dealer conducts or proposes to conduct business operations. This report shall include the specific information required by paragraphs (a) through (p) of § 32.8. Essentially these paragraphs require detailed information concerning the operations of the dealer. Among other things, disclosure is required with respect to the dealer's use of the futures market, the extent to which it will use premiums received from purchasers to cover option transactions, the extent and justification of payments and fees received from purchasers, the manner in which a purchaser will acquire the commodity or futures contract which is the subject of an option, identity and location of depositories of the commodities and any aspects of the dealer's business which may affect its solvency or ability to perform its obligations to purchasers.

In addition, § 32.8(a) requires a description of the commodity option transactions the dealer is offering or proposing to offer with a list of the commodities and futures contracts which are the subject of such transactions, including the name of the contract market or exchange on which such futures contracts are traded. Section 32.8(b) requires a description of the extent to which the dealer assumes financial responsibility for the commodity option transactions; the extent to which and the circumstances under which the dealer acts solely as agent for another person who assumes such financial responsibility; and a summary of the responsibilities and obligations of each person in the transaction or chain of transactions to the other, including a statement of the responsibilities and obligations to the purchaser or prospective purchaser of each dealer. Section 32.8(f) requires a summary of the material terms and conditions of all agreements, contracts or other documents entered into or proposed to be entered into between a dealer and a purchaser or prospective purchaser, together with copies of all such documents. Section 32.8(h) requires disclosure of the extent and manner in which the dealer proposes to obtain and hold, or have a legal right to acquire, the actual commodity or futures contract which is the subject of a commodity option transaction entered into or proposed to be entered into by the dealer. Section 32.8(o) requires a description of the manner in which the dealer expects to derive income from commodity option transactions.

Financial Reporting

Section 32.9 of the proposed rules requires that, within 60 days after the filing of its application for registration, the commodity option dealer must file an amendment to the application containing audited financial statements, including a detailed balance sheet as of a date not more than 90 days prior to the date of the filing of the amendment, a statement of the dealer's net working capital as at such date and the dealer's statements of income, changes in each element of corporate stockholders' equity or in partners' or sole proprietor's capital, changes in subordinated borrowings and changes in financial position, all for the three fiscal years immediately preceding the date of the audited balance sheet being filed. The financial statements required to be filed by the commodity option dealer, include financial statements for any consolidated groups, and must be prepared and audited in the manner and accompanied by the reports, statements and consents, specified in § 32.9.

Computation and Reporting of Net Working Capital

Section 32.10 of the proposed rules concerns the computation of net working capital which must be maintained by commodity option dealers in order to offer or enter into transactions. The proposed rules provide that the commodity option dealer must compute net working capital as of the close of each business day and that such computation must be made no later than the opening of the next business day, in accordance with generally accepted accounting principles consistently applied and subject to the provisions of the proposed rules.

The method of computing net working capital contained in the proposed rules is designed to take into account the exposure which a commodity option dealer may experience should the market move against the dealer and in favor of a purchaser. In such event, the computation of net working capital will result in an increase in current liabilities, and as a consequence, a decrease of net working capital. Should the dealer not have sufficient net working capital to absorb the decrease and, at the same time, maintain the minimum net working capital required by the proposed rules, it must provide additional capital to the enterprise in order lawfully to continue to offer or sell commodity option transactions.

Paragraph (a) of § 32.10 contains the definitions which are used in connection with the computation of net working capital. The definitions are self-explanatory. However, of particular importance is the definition of "cover," since the computation of net working capital contemplates that the impact on current liabilities resulting from an adverse market move may be reduced by the ownership of a commodity or futures contract. In connection with that definition the Commission wishes to emphasize, however, that, under § 32.10(a)(1), the ability of a commodity option dealer to "cover" its position will vary depending upon the type of commodity option transaction involved. In the case of a commodity option transaction involving an actual commodity, a dealer is permitted to cover its position only by the unencumbered ownership of the same commodity, with substantially the same grade, quality, and delivery point, as that which is the subject of the commodity option transaction. In the case of a commodity option transaction involving a contract for future delivery, cover will be permitted only by the unencumbered ownership of the same contract for future delivery executed on the same contract market as the futures contract which is the subject of the commodity option transaction. As a result of these definitions, therefore, a commodity option dealer may not for purposes of the computation of net capital "cover" a commodity option transaction involving an actual commodity by means of the ownership of a futures contract; and, conversely, may not "cover" a commodity option transaction involving a futures contract by means of the ownership of an actual commodity or of a futures contract other than that which is the subject of the commodity option transaction. The Commission is particularly interested in receiving comments with respect to its definition of "cover." In this connection, the Commission is interested in comments as to what constitutes an appropriate futures contract for purposes of cover, especially in regards to distant as opposed to near delivery month contracts.

The following examples of the computation of net working capital for commodity option dealers under § 32.10(b) are provided to explain the operation of this provision and assist interested persons in evaluating the proposal. In each of the examples, the selling unit of the commodity involved is 1000 pounds and the "striking prices" and "market values" indicated represent the price per pound times 1000 pounds. Each of the examples deals with an "open commodity option transaction," as defined in § 32.10(a)(3).

Example 1. The net working capital of a dealer, computed in accordance with generally accepted accounting principles is $200,000 before any commodity option transaction is entered into by the dealer. The dealer then sells a "call" option transaction involving either an actual commodity or a futures contract at a striking price of $20,000 and requires a premium from the purchaser of $5,000. Under § 32.10(b)(2), the $5,000 premium would be excluded from the computation of net working capital. If the option transaction is not covered, and the market value of the commodity or the futures contract which is the subject of the transaction is $20,000, the amount by which the market value ($20,000) exceeds 90% of the striking price ($20,000 times .9 equals $18,000), or $2,000, would be included, pursuant to section 32.10(b)(4), in current liabilities. The net working capital of the dealer would accordingly be $198,000 ($200,000 minus $2,000). Similarly, if the market value is $22,000, the resulting net working capital would be $196,000 *i.e.*, $22,000 (market value) minus $18,000 (90% of the striking price), or $4,000, subtracted from $200,000 (original net working capital). Alternatively, if the market value is $17,000, no additional amount would be required to be included in current liabilities since the $17,000 market value does not exceed 90% of the striking price ($18,000) and thus net working capital of the dealer would remain at $200,000.

Example 2. If the "call" option transaction referred to in Example 1 above involves an actual commodity and the dealer covers with the actual commodity, the market value of the actual commodity would also be allowable as a current asset under § 32.10(b)(7).

Example 3. If the dealer sells a "call" option transaction involving a futures contract at a striking price of $20,000, and subsequently the market value of the futures contract which is the subject of that transaction moves to $23,000, the dealer would be required by section 32.10(b)(4), to include $5,000 in current liabilities—$23,000 (market value) minus $18,000 (90% of striking price). Were the dealer then to cover the commodity option transaction with a long futures contract, § 32.10(b)(8)(A) would become operative in lieu of § 32.10(b)(4). Thus, if the dealer purchased the long futures contract at $23,000, and the market value of that futures contract is $23,000, the difference between the market value of the futures contract ($23,000) and 90% of the striking price ($18,000), or $5,000, must be included in current liabilities, pursuant to § 32.10(b)(8)(A). If the market value of the futures contract thereafter falls to $21,000, then the difference between the market value ($21,000) and 90% of the striking price ($18,000), or $3,000, must be included in current liabilities. In the latter situation, the dealer would, under section 32.10(b)(3), also include in current liabilities the unrealized loss on the futures contract of $2,000 ($23,000 purchase price of futures contract minus $21,000 market value). On the other hand, if the market value of the futures contract rose to $25,000, the dealer would include the unrealized gain of $2,000 ($25,000 minus $23,000) as a current asset pursuant to section 32.10(b)(3), as well as the difference between the market price ($25,000) and 90% of the striking price ($18,000), or $7,000, as a current liability in accordance with section 32.10(b)(6). If the market value of the futures contract drops to $10,000, the dealer would include the difference between the market value ($10,000) and 90% of the striking price ($18,000), or $8,000, as a current asset, but only if the premium collected or accrued equaled or exceeded that difference. In the present examples, however, the premium collected or accrued was only $5,000. Accordingly, under the proviso in § 32.10(b)(8), only $5,000 of the $8,000 difference can be included in current assets. The dealer would also be required in this case to mark the futures contract to the market, pursuant to § 32.10(b)(3), by including the entire unrealized loss of $13,000 ($23,000 purchase price of future minus $10,000 market value) as a current liability.

Example 4. The dealer sells a "put" option transaction involving either an actual commodity or a futures contract at a striking price of $20,000. If the option transaction is not covered[7] and the market value of the commodity or the futures contract which is the subject of that transaction is $20,000, the amount by which the market value of the commodity or futures contract ($20,000) falls below 110% of the striking price ($20,000 times 1.1 equals $22,000), or $2,000, must be included in current liabilities under § 32.10(b)(5). Alternatively, if the market value is $18,000, then the amount by which the market value ($18,000) falls below 110% of the striking price ($22,000), or $4,000, must be included in current liabilities pursuant to that section. On the other hand, if the market value is $23,000, no additional amount would be required, under this section, to be included in current liabilities since the market value ($23,000) is not below 110% of the striking price ($22,000).

Example 5. The dealer sells a "put" option transaction involving a futures contract at a striking price of $20,000. The market value of the futures contract which is the subject of that transaction subsequently falls to $18,000. Thus, the dealer, as in Example 4 above, would be required to include $4,000 in current liabilities under § 32.10(b)(5). Were the dealer then to cover the commodity option transaction with a short futures contract, § 32.10(b)(8)(B) would become operative in lieu of § 32.10(b)(5). Thus, if the dealer purchased the short futures contract at $18,000, and the market value of that futures contract is $18,000, the difference between the market value of the futures contract ($18,000) and 110% of the striking price ($22,000), or $4,000, must be included as a current liability pursuant to § 32.10(b)(8)(B). If the market value of the futures contract thereafter moves to $20,000, then the difference between the market value ($20,000) and 110% of the striking price ($22,000), or $2,000, must be included in current liabilities, along with the unrealized loss on the short futures contract of $2,000 ($20,000 market value minus $18,000 purchase price of future), as required by § 32.10(b)(3). On the other hand, if the market value of the futures contract falls to $16,000, the dealer would include the unrealized gain of $2,000 ($18,000 minus $16,000) in current assets. In this latter case, however the difference between the market value ($16,000) and 110% of the striking price ($22,000), or $6,000, must concurrently be included in current liabilities in accordance with § 32.10(b)(8)(B).

So that the Commission may be in a position to ascertain the financial condition of commodity option dealers, as measured by the net working capital, levels, without necessitating an on site examination or investigation of such persons' records (although the Commission has authority to do so at any time[8]) section 32.10(c) of the proposed rules requires that, within ten days after the end of each month, each commodity option dealer file with the Commission a statement of its net working capital as of the end of such month, computed in accordance with the proposed rules. In addition, paragraph (d) of this section provides that if, on and after April 15, 1976, the net working capital of a commodity option dealer is equal to or less than $100,000 as of the close of any business day the dealer must immediately notify the Commission by telegram, promptly confirmed in writing, of its net working capital as of the close of each such business day. The Commission believes that these provisions are particularly important to enable it to monitor the financial solvency of commodity option dealers on a continuing basis and to take appropriate action in the event the net working capital position of a commodity option dealer falls to a level which raises questions as to whether such dealer will be able to perform its obligations under existing transactions and thus whether such dealer should be permitted to continue to engage in business. It should be re-emphasized that if a dealer's net working capital is below the minimum requirement set forth in the proposed rules at the close of any business day, it must, pursuant to § 32.2, immediately cease offering and entering into any further transactions, until such time as its net working capital complies with the requirement—notification to the Commission as required by § 32.10(d) does not permit the dealer to continue to engage in transactions. At such time as the net working capital of the dealer again reaches the required minimum level, it may resume the offer and sale of transactions, provided it is in compliance with all of the other provisions of the proposed rules.

MAINTENANCE OF BOOKS AND RECORDS

Section 32.11 of the proposed rules imposes a requirement on each commodity option dealer to keep such books and records as are necessary to make and record daily the net working capital computation required by the rules, to maintain daily statements of the computation of net working capital and to have other books and records as are sufficient to enable the Commission to examine the records of all financial aspects of each and every transaction entered into by the commodity option dealer. The Commission is interested in receiving comments, particularly for purposes of promulgating permanent rules, as to what specific books and records the Commission should require dealers to maintain to assure proper internal control of their financial operations.

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[7] As proposed, the rules do not contemplate that a dealer would be able to cover a "put" option transaction involving an actual commodity.

[8] *See* section 6(b) of the Act, 7 U.S.C. § 15.

UNLAWFUL REPRESENTATIONS

Section 32.12 of the proposed rules make it unlawful for any commodity option dealer, or any affiliated person thereof, to claim that the Commission, by declaring a registration effective or otherwise, has approved either the dealer or any transaction offered, entered into, or confirmed by the dealer. While the Commission will seek to prevent the dissemination of false or misleading information about dealers, it cannot conduct an investigation in every instance to determine the accuracy or adequacy of information contained in an application for registration or in amendments or reports filed. Accordingly, registration with the Commission cannot and does not indicate Commission approval of a dealer or of the transactions in which it may engage.

ANTIFRAUD

Section 32.13, the Commission's antifraud rule in connection with commodity option transactions, has been included as part of the proposed rules so as to have all rules affecting commodity option transactions in one place in the Code of Federal Regulations. This section is the same rule that is presently in effect, contained in 17 CFR § 30.01, modified to incorporate certain of the definitions set forth in the proposed rules.

In consideration of the foregoing, the Commission hereby proposes to amend Chapter I of Title 17 of the Code of Federal Regulations effective April 15, 1976, by deleting §§ 1.19 and 30.01 thereof, and by adding a new Part 32, as follows:

1.19 [Removed]

1. Section 1.19 is removed.

30.01 [Removed]

2. Section 30.01 is removed.

3. Part 32 is added to read as follows:

Sec.
32.1 Definitions.
32.2 Unlawful commodity option transactions.
32.3 Exemptions.
32.4 Application for registration of commodity option dealer.
32.5 Content of application.
32.6 Effectiveness of registration: denial, suspension and revocation thereof.
32.7 Amendments to application.
32.8 Report of business operations of commodity option dealer.
32.9 Financial reporting of commodity option dealer.
32.10 Computation and reporting of net working capital of commodity option dealer. dealer.
32.11 Maintenance of books and records.
32.12 Unlawful representations.
32.13 Fraud in connection with commodity option transactions.

AUTHORITY: Secs. 2(a)(1), 4c(b) and 8a of the Commodity Exchange Act, 7 U.S.C.A. §§ 2, 6c(b) and 12a (Supp. 1, 1975).

§ 32.1 Definitions.

As used in this Part—

(a) "Purchaser" means any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option transaction from any commodity option dealer;

(b) "Commodity option transaction" means any transaction involving any commodity regulated under the Act but not specifically set forth in Section 2(a) of the Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93–463 (October 23, 1974), which is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty";

(c) "Commodity option dealer" and "dealer" each means any person engaged in the business of offering to enter into, entering into, or confirming the execution of, commodity option transactions, whether or not that person makes, underwrites, issues or otherwise assumes any financial responsibility for any commodity option transaction;

(d) "Affiliated person" means any general partner, officer, director, manager, salesperson or employee of a person (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by another person, except that (1) any employee acting solely in a clerical or ministerial capacity, and (2) any manager, salesperson or employee of a dealer acting solely in a capacity unrelated to commodity option transactions, shall not be deemed to be an "affiliated person";

(e) "State" means any state or territory of the United States, or the District of Columbia;

(f) "Promotional material" includes any standardized form of report, letter, circular, memorandum or similar written literature, any text of a standard oral presentation, or any communication for publication in any newspaper, magazine or similar medium or for broadcast over television, radio or other electronic medium, which is or is proposed to be disseminated or directed by a dealer to a purchaser or prospective purchaser; and

(g) "Premium" means the charge to a purchaser for entering into a commodity option transaction.

§ 32.2 Unlawful commodity option transactions.

(a) On and after April 15, 1976, it shall be unlawful for any commodity option dealer to offer to enter into, enter into, or confirm the execution of any commodity option transaction unless from and after that date—

(1) The dealer's net working capital, as computed pursuant to section 32.10 (b) of this Part, shall be at all times in excess of $100,000; and

(2) The dealer's total assets shall at all times exceed its total liabilities as determined in accordance with generally accepted accounting principles consistently applied.

(b) On and after May 28, 1976, it shall be unlawful for any commodity option dealer to offer to enter into, enter into, or confirm the execution of, any commodity option transaction unless the commodity option dealer is registered with the Commission in accordance with this Part and such registration shall not have expired, been suspended or revoked.

(c) On and after May 28, 1976, it shall be unlawful for any commodity option dealer registered with the Commission in accordance with this Part to offer to enter into, enter into, or confirm the execution of, any commodity option transaction unless such dealer, in or in connection with each offer to enter into a commodity option transaction, informs each prospective purchaser that the dealer has filed with the Commission an application, and any amendments thereto, disclosing information concerning the dealer; its personnel, financial condition and business operations, and that copies of such filings are available for public inspection during normal business hours at all offices of the dealer and at the offices of the Commission in Washington, D.C.

§ 32.3 Exemptions.

(a) The provisions of this Part (other than the provisions relating to fraud set forth in section 32.13) shall not apply to a commodity option transaction offered or entered into by a commodity option dealer:

(1) Where such transaction is offered to or entered into with a producer, processor or consumer of, or a person handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and such producer, processor, consumer or person is offered or enters into the commodity option transaction solely for purposes related to its business as such; or

(2) Where the dealer, in any period of twelve consecutive months, offers or enters into commodity option transactions with less than 10 persons other than those described in paragraph (a)(1) of this section: provided, however, that in computing the number of persons for purposes of this paragraph only, there shall be counted as a separate person (A) each person who is a natural person, unless the person is the relative or spouse of another person, or relative of such spouse, who shares the same house as the person, in which case such family group shall be counted as one person and (B) each person who is not a natural person, unless it was organized for, or has as its primary purpose, the purchase or acquisition, directly or indirectly, of commodity option transactions, in which case each beneficial owner of an interest in that person shall be counted as a separate and distinct person.

(b) The Commission may, by order, upon written request or upon its own motion, exempt any person, either unconditionally or on a temporary or other conditional basis, from any provisions of this Part (other than the provisions relating to fraud set forth in § 32.13), if it finds that it would not be contrary to the public interest to grant such exemption.

§ 32.4 Application for registration of commodity option dealer.

(a) An original and four copies of an application for registration of a commodity option dealer, in the form required by § 32.5 of this Part, shall be filed with the Commission at its offices in Washington, D.C. Every commodity option dealer who files an application for registration shall concurrently submit one copy of the application to the official administering the securities laws of each state wherein the commodity option dealer maintains an office, or is offering to enter into, entering into, or confirming the execution of, or proposes to offer, enter into, or confirm the execution of, commodity option transactions. Should a securities laws administrator designate in writing to the Commission an alternative official to whom a copy of the application is to be submitted, the Commission shall specify such designated official and his location by public notice.

(b) At the time of filing of an application for registration with the Commission, the commodity option dealer shall pay a registration fee of $750: the application shall not be deemed to have been filed unless it is accompanied by a money order or a check drawn to the order of the Treasurer of the United States in such amount.

(c) The application for registration filed with the Commission in accordance with paragraph (a) of this section shall be filed with a cover page dated and manually signed by the commodity option dealer if an individual proprietorship, by an executive officer on behalf of a corporate dealer, by a general partner on behalf of a dealer which is a partnership, or by an official performing executive functions on behalf of a dealer which is any other form of organization, containing:

(1) A statement that the application is filed pursuant to the requirements of this Part and of Section 4c(b) of the Act;

(2) A certification by the commodity option dealer that all statements contained in or submitted in connection with the application are true and correct; and

(3) If the commodity option dealer is a corporation or other entity managed by a group similar to a board of directors, a certification that the filing of the application and its contents have been passed upon and duly authorized by the board of directors or management group of such other entity.

§ 32.5 Content of application.

(a) An application for registration of a commodity option dealer, other than an application made by a person registered with the Commission as a futures commission merchant, shall contain, in the following order, appropriately itemized to conform to the paragraphs of this section:

(1) The name under which the commodity option dealer is doing or intends to do business and, if a corporation or other similar entity, the state of incorporation or organization;

(2) The address of the principal business office and all branch offices of the commodity option dealer, the telephone number of each such office and the names of all principal and branch-office managers;

(3) A duly completed and signed CEA Form 94 (biographical information) for the dealer, all affiliated persons of the dealer, and all persons owning 10% or more of the equity or other ownership interest in the dealer;

(4) A description of (A) all pending actions or proceedings instituted by a federal or state agency or department regulating the offer, purchase or sale of commodities or securities, or by a contract market, securities exchange, or commodities or securities self-regulatory association, against the commodity option dealer or any affiliated person thereof, and (B) any other material pending judicial or administrative proceeding instituted against the commodity option dealer or any affiliated person thereof, or against the property of any of them, or to which their property is subject;

(5) A list of the states in which the commodity option dealer is offering or proposes to offer any commodity option transaction;

(6) The name and address of an agent authorized by the commodity option dealer to receive notices and service of legal process at its principal office and in each state in which the commodity option dealer is offering and proposes to offer any commodity option transaction;

(7) Complete factual details of the events specified below if, the commodity option dealer, or any affiliated person thereof:

(i) has been convicted of any felony or any misdemeanor—

(*A*) Involving any transaction or advice concerning any commodity or security.

(*B*) Arising out of the conduct of the business of a commodity option dealer, futures commission merchant, associated person, floor broker, commodity trading advisor, commodity pool operator, securities broker or dealer, securities investment adviser investment company, or as an affiliated person of any of the foregoing.

(*C*) Involving embezzlement, bribery, the receipt of any form of payment to influence or control the affairs or income of any person, fraudulent conversion, misappropriation of funds or securities, counterfeiting, or otherwise involving the misuse of the funds or property of others.

(*D*) Involving gambling-type crimes, or

(*E*) Involving the violation of sections 1341, 1342 or 1343 of Title 18, United States Code (relating to mail fraud);

(ii) Has been convicted of any felony other than that listed in paragraph (a)(7)(i) of this section:

(iii) Is or has been permanently or temporarily enjoined by a court of competent jurisdiction, or prohibited by a federal or state administrative agency or department, upon consent or otherwise, from—

(*A*) Acting as a commodity option dealer, futures commission merchant, associated person, floor broker, commodity trading advisor, commodity pool operator, securities broker or dealer, securities investment adviser, investment company, or as an affiliated person of any of the foregoing, or

(*B*) Engaging in any conduct (a) arising out of any activity described in paragraph (a)(7)(iii)(*A*) of this section, (b) involving misstatements or omissions of a material fact or facts, fraud or deceit, or (c) constituting a violation of any statute, or of any regulation, rule or order of any federal or state administrative agency or department, involving regulation of the offer, purchase or sale of commodities or securities, or of any rule of a contract market, securities exchange, or commodities or securities self-regulatory association;

(iv) Has had registration as a commodity option dealer, futures commission merchant, associated person, floor broker, commodity trading advisor, commodity pool operator, securities broker or dealer or securities investment adviser or investment company, denied, suspended or revoked by any federal or state administrative agency or department regulating the offer, purchase or sale of commodities or securities;

(v) Is or has been, by reason of any misconduct, suspended or expelled as a member of, or denied access to, any contract market, securities exchange, or commodities or securities self-regulatory association:

(vi) Has been found by any court of competent jurisdiction, by any federal or state administrative agency regulating the offer, purchase or sale of securities or commodities, or by any contract market, securities exchange, or commodities or securities self-regulatory association, to have violated any statute, or any rule, regulation or order of such agency or department, or any rule (other than a rule of decorum) of a contract market, securities exchange, or commodities or securities self-regulatory association;

(vii) Except an affiliated person who acts solely as a salesperson of the dealer, is or has been the subject of proceedings under the Federal Bankruptcy Act, 11 U.S.C. § 1, *et seq.*, or similar laws relating to the relief of debtors or the protection of customers, or controls or has controlled or participates or has participated in the control of, or serves or has served in an executive capacity for, any person which is or has been the subject of such proceedings; or

(viii) Is or has been debarred by any agency of the United States from contracting with the United States.

(8) Copies of all promotional material and of all contracts, accounts, agree-

ments or other documents, pursuant to which the commodity option dealer is offering, proposing to offer, or entering into, commodity option transactions;

(9) A balance sheet of the dealer, audited by an independent certified public accountant, as of the end of the dealer's most recent fiscal year unless such fiscal year has ended within 90 days prior to the date of filing of the application, in which case the audited balance sheet may be as of the end of the preceding fiscal year, or, if no such audited balance sheet is available, then an unaudited balance sheet as of the end of the most recent fiscal year; and

(10) A statement setting forth the computation of the dealer's net working capital pursuant to this Part as of the date of the balance sheet described in paragraph (a) (9) of this section.

(b) An application for registration of a commodity option dealer filed by a person registered with the Commission as a futures commission merchant shall contain:

(1) A statement that such person is so registered as a futures commission merchant and the effective date of such registration;

(2) The information specified in paragraphs (a) (2), (a) (4), (a) (5), (a) (6), (a) (8), (a) (9) and (a) (10) of this section.

§ 32.6 Effectiveness of registration: denial, suspension and revocation thereof.

(a) The Commission shall declare effective the registration of a commodity option dealer if it appears that the requirements of this Part have been satisfied. The Commission may, after notice and opportunity for hearing, deny the registration of a commodity option dealer, if it finds that the dealer is unfit to engage in the business of a commodity option dealer—

(1) Because the dealer, whether prior or subsequent to becoming such, or any affiliated person thereof, whether prior or subsequent to becoming so affiliated:

(i) Has failed to comply with any of the provisions of this Part;

(ii) Has made or caused to be made in any application for registration, amendment thereto, or report required to be filed with the Commission under this Part, under any provision of the Act, or under any rule or regulation promulgated thereunder, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, amendment, or report any material fact required to be stated therein;

(iii) Has engaged in any practice of the character prohibited by the Act; or

(iv) Has engaged or is engaging in operations which threaten the financial solvency of any commodity option transaction or tend to permit manipulation or fraud in or in connection with any offer to enter into, entry into or confirmation of the execution of any commodity option transaction; or

(2) For other good cause shown, including, but not limited to, the occurrence of any of the events specified in § 32.5(a) (7) of this Part, or the grounds for denial of registration of other persons required to register under the Act announced by the Commission in 40 FR 28125 (July 3, 1975).

(b) The Commission may, after notice and opportunity for hearing, suspend or revoke the registration of a commodity option dealer if cause exists which would warrant a denial of registration under paragraph (a) of this section.

(c) All registrations under this Part shall expire one year from the date such registration becomes effective, and shall be renewed upon application subject to the same requirements as in the case of an initial application: *provided, however*, that all registrations shall in any event terminate on the effective date the Commission revokes or supersedes the provisions of this Part.

(d) A person registered under this Part 32 who furnishes the services specified in section 2a(1) of the Act is not included in the term commodity trading advisor if:

(1) At the time such services are furnished, such person is registered under this section as a commodity option dealer, and such registration shall not have expired, been suspended or revoked; and

(2) The furnishing of such services is solely incidental to the conduct of such person's business or profession as a commodity option dealer.

§ 32.7 Amendments to applications.

(a) If the information contained in any application for registration as a commodity option dealer, or in any amendment thereto, has become incomplete or inaccurate in any material respect either by reason of a change in circumstances, change in affiliated persons, change in the states wherein the dealer is offering or proposes to offer commodity option transactions or change in promotional material, or for any other reason, the dealer shall, not later than 30 days after such occurrence, file an amendment to the application correcting or supplementing the information it contains.

(b) Any amendment to an application for registration shall be filed and submitted in such a manner and in such form as is prescribed for an application in section 32.4 (a) and (c) of this Part.

§ 32.8 Report of business operations of commodity option dealer.

No later than 30 days after the filing of an application for registration of a commodity option dealer, the dealer shall file an amendment to the application, in accordance with section 32.7(b) of this Part, containing a detailed report in narrative form concerning the nature of, and manner in which, the dealer conducts or proposes to conduct business operations, including—

(a) A description of the commodity option transactions the dealer is offering or is proposing to offer, with a list of the commodities and/or futures contracts which are the subjects of such transactions, including the name of the contract market, exchange or other board of trade on which such futures contracts are traded;

(b) The extent to which the dealer makes, issues, underwrites or otherwise assumes financial responsibility for the commodity option transactions entered into or proposed to be entered into by the dealer, the extent to which and circumstances under which the dealer acts solely as agent for another person who makes, issues, underwrites or otherwise assumes financial responsibility for the commodity option transactions entered into or proposed to be entered into by the dealer (including the name and address of such other person), and a summary of the responsibilities and obligations of each person in the transaction or chain of transactions to the other, including a statement of the responsibilities and obligations to the purchaser or prospective purchaser of each dealer;

(c) A detailed description of the extent and manner in which the dealer utilizes or proposes to utilize the facilities of a contract market, exchange or other board of trade in connection with commodity option transactions including a description of the circumstances, if any, under which the dealer may use or permit the use of the premium charged to and received from a purchaser to take positions in the futures market with respect to the commodity or futures contract which is the subject of the commodity option transaction;

(d) The extent and manner in which the premium charged to and received from a purchaser, any actual commodity or any futures contract which is used to cover any commodity option transaction entered into or proposed to be entered into by the dealer, any evidences of ownership thereof, or any funds or property due and owing to a purchaser, are or will be segregated from, or commingled with, those of other purchasers or with the assets of the dealer, including the name and location of the accounts or depositories, if any, where the same is segregated;

(e) The extent and manner in which the dealer proposes to receive payments or fees from purchasers in connection with commodity option transactions and a description of the consequences to a purchaser of the failure to make any required payment;

(f) A summary of material terms and conditions of all agreements, contracts or other documents entered into or proposed to be entered into, between the dealer and a purchaser or prospective purchaser, together with copies of all such documents;

(g) A statement of the manner in which a purchaser is to acquire and receive delivery of the commodity or futures contract which is the subject of a commodity option transaction, and a statement of the person or persons to whom full payment is to be made upon exercise of the option and of the maximum delivery time within which such commodity or futures contract will be delivered or otherwise made available to the purchaser upon exercise of the option;

(h) The extent and manner in which the dealer proposes to obtain and hold, or have a legal right to acquire, the actual commodity or futures contract which is the subject of a commodity option transaction entered into or proposed to be entered into by the dealer;

(i) The location and identity of any depository or other person holding possession, on behalf of the dealer, of the commodity which is the subject of a commodity option transaction entered into or proposed to be entered into by the dealer, or any evidences of ownership thereof, and the substance of the contractual or other relationship between the dealer and such person;

(j) A description of the material aspects of the dealer's business operations which may affect the dealer's solvency or the dealer's ability to deliver or to pay for the delivery to the purchaser of commodities or futures contracts which are the subject of the commodity option transactions entered into or proposed to be entered into by the dealer, including the effect that the bankruptcy of the dealer or any other person with whom the dealer has a contractual or other relationship (except the purchaser) would have upon the rights of the purchaser to receive possession of the commodity, or adjustment on the value of the futures contract, which is the subject of the commodity option transaction;

(k) A summary of the manner and circumstances, if any, by which the dealer intends to, or will, repurchase or make adjustment for the interest involved in any commodity option transaction, or the underlying actual commodity, including a description of the dealer's capability to repurchase or adjust, and of the conditions to any commitment by the dealer to do so;

(l) The method by which the dealer establishes the premium to be charged to a purchaser or the charge at which the dealer will repurchase;

(m) The nature of the services to be provided in return for, and the extent and amount of, all storage charges, interest charges, commissions, and similar fees or charges, other than the premium, which will be required of a purchaser in connection with a commodity option transaction;

(n) A statement of the risks inherent in commodity option transactions generally and a description of any material risks associated with, or with respect to, the particular operations of the dealer;

(o) A description of the manner in which the dealer expects to derive income from commodity option transactions;

(p) A description of such other aspects of the dealer's business or proposed operations as may affect the financial solvency of a commodity option transaction to be offered or entered into by the dealer, and as may affect the possibility of manipulation or fraud in or in connection with any offer to enter into, entry into, or confirmation of the execution of, any commodity option transaction; and

(q) Such other information and documentation as the Commission may request.

§ 32.9 Financial reporting of commodity option dealer.

(a) Within 60 days after the filing of an application for registration of a commodity option dealer, the dealer shall file an amendment to the application, in accordance with § 32.7(b), containing—

(1) A detailed balance sheet of the commodity option dealer audited by an independent certified public accountant as of a date not more than 90 days prior to the date of the filing of the amendment, disclosing the nature and amount of assets and liabilities and the net working capital of such dealer;

(2) The commodity option dealer's statements of income, changes in each element of corporate stockholders' equity or in partners' or sole proprietor's capital, changes in subordinated borrowings and changes in financial position, all for the three fiscal years immediately preceding the date of the audited balance sheet being filed (or, if the dealer has been in business for less than three years, then for such time as the dealer has been in business) and for the interim period, if any, between the end of the most recent of such fiscal years and the date of the balance sheet being filed, together with statements of income for the corresponding interim period for the preceding fiscal year, all of which statements shall be audited by an independent certified public accountant to the date of the audited balance sheet being filed; and

(3) A statement setting forth the computation of net working capital of the dealer, pursuant to this Part, as of the date of the balance sheet filed under paragraph (a)(1) of this section.

(b) The financial statements filed pursuant to this section shall contain appropriate disclosure footnotes, and shall be prepared in accordance with generally accepted accounting principles consistently applied and otherwise in accordance with this Part.

(c) If the dealer is a member of a consolidated group for financial reporting purposes, a consolidated balance sheet and consolidated financial statements of such group as of the date and for the periods covered by, similar in form and content to, and audited in the manner as, the financial statements filed pursuant to paragraphs (a) and (b) of this section.

(d) Subject to appropriate variation to conform to the nature of the business, the following items shall be included in each statement of income filed pursuant to this section: net sales or operating or other revenues, cost of goods sold or operating or other expenses (or gross profit), interest expense, income tax expense, income from continuing operations, income from discontinued operations (less applicable tax), income or loss before extraordinary items, extraordinary items (less applicable tax), cumulative effects of changes in accounting principles, and net income or loss.

(e) The financial statements filed pursuant to this section shall be accompanied by the manually signed and dated report of each independent certified public accountant auditing such statements, containing the opinion of such accountant that:

(1) Such financial statements fairly present the financial position of the dealer as of the date of the balance sheet of the dealer being filed, and the results of the dealer's operations for the periods then ended, in conformity with generally accepted accounting principles consistently applied; and

(2) Such accountant's examination was performed in accordance with generally accepted auditing standards and for the purpose of the filing of the amendment by the dealer.

(f) The financial statements filed pursuant to this section shall be accompanied by the written consent of each independent certified public accountant whose report is included in the amendment as to the use of the accountant's name and of such report in the amendment, together with a signed statement of such accountant as to any existing circumstances or facts which would tend to raise any question as to the independency of such accountant, or if there are no such facts or circumstances, a signed statement to that effect.

§ 32.10 Computation and reporting of net working capital of commodity option dealer.

(a) As used in this section—

(1) "Cover" means to own, free and clear of all claims, liens and other encumbrances (including outstanding margins)

(i) In the case of a commodity option transaction involving an actual commodity: the same commodity, with substantially the same grade, quality, and delivery point, as that which is the subject of the commodity option transaction; or

(ii) In the case of a commodity option transaction involving a contract for future delivery: the same futures contract executed on the same contract market as the futures contract which is the subject of the commodity option transaction;

(2) "Striking price" means the price fixed under the terms of a commodity option transaction at which the purchaser, upon exercise, may purchase or sell the actual commodity which is the subject of the commodity option transaction, or upon which an adjustment to a purchaser with respect to the futures contract which is the subject of a commodity option transaction is based;

(3) "Open commodity option transaction" means any commodity option transaction entered into by a dealer in which the dealer's obligations to a purchaser arising therefrom have not ex-

pired, been fully performed, or otherwise been lawfully terminated.

(b) On and after April 15, 1976, the net working capital of a dealer shall be computed as of the close of each business day, such computation to be made no later than the opening of the next business day, in accordance with generally accepted accounting principles consistently applied, subject to the following rules:

(1) There shall be excluded from current assets any assets not located within the territorial limits of the United States;

(2) There shall be excluded from current assets and from current liabilities the premium charged to any purchaser in or in connection with any open commodity option transaction;

(3) All commodity futures contracts of the dealer shall be marked to the market daily with the unrealized gain or loss included in current assets or current liabilities, respectively;

(4) Except as provided in paragraph (b)(8) of this section, with respect to any open "call" commodity option transaction, there shall be included as a current liability the amount by which the then current market value for the actual commodity or futures contract which is the subject of such transaction, at the close of the business day for which the computation is made, exceeds 90% of the striking price for such transaction;

(5) Except as provided in paragraph (b)(8) of this section, with respect to any open "put" commodity option transaction, there shall be included as a current liability the amount by which the then current market value for the actual commodity or futures contract which is the subject of such transaction, at the close of the business day for which the computation is made, falls below 110% of the striking price of such transaction;

(6) Except as provided in paragraph (b)(8) of this section, with respect to any open "put-call" ("double") commodity option transaction, there shall be included in current liabilities, whichever is the larger of (A) the amount which results if such transaction is deemed to be an open "call" commodity option transaction and is computed pursuant to paragraph (b)(4) of this section, or (B) the amount which results if such transaction is deemed to be an open "put" commodity option transaction and is computed pursuant to paragraph (b)(5) of this section;

(7) If an open "call" commodity option transaction is covered in whole or in part by the actual commodity, there may be included in current assets the market value of the actual commodity;

(8) If an open commodity option transaction is covered in whole or in part by a commodity futures contract the following rules shall apply in lieu of paragraphs (b)(4), (b)(5) and (b)(6) of this section—

(i) With respect to any open "call" commodity option transaction, there shall be included as a current asset or a current liability the difference between the then current market value of the futures contract and 90% of the striking price for such transaction, but only to the extent that such transaction is covered by such futures contract;

(ii) With respect to an open "put" commodity option transaction, there shall be included as a current asset or a current liability the difference between the then current market value of the futures contract and 110% of the striking price for such transaction, but only to the extent that such transaction is covered by such futures contracts;

(iii) With respect to an open "put-call" (double) commodity option transaction, there shall be included as a current asset or a current liability, which ever results in the lower net working capital of (i) the difference which results if such transaction is deemed to be an open "call" commodity option transaction and is computed pursuant to paragraph (b)(8)(i) of this section, or (ii) the difference which results if such transaction is deemed to be an open "put" commodity option transaction and is computed pursuant to paragraph (b)(8)(ii) of this section;

Provided, however, That any difference computed pursuant to paragraph (b)(8)(i), (b)(8)(ii), or (b)(8)(iii) of this section, may be included as a current asset only to the extent of the premium charged to and received from a purchaser in connection with an open commodity option transaction;

(9) No open commodity option transaction shall be offset (netted) against any other open commodity option transaction, or any other commodity option transaction entered into by the dealer, in computing net working capital or in presentation on any balance sheet or statement of net working capital of the dealer.

(c) No later than 10 days after the end of each month, commencing with the month in which the dealer has filed an application for registration pursuant to this Part, the dealer shall file an amendment to the application, in accordance with § 32.7(b), containing a statement of its net working capital as of the close of the last business day of such month, computed pursuant to paragraph (b) of this section.

(d) If, on and after April 15, 1976, the net working capital of a commodity option dealer, computed pursuant to this Part, is equal to or less than $100,000 as at the close of any business day, such dealer shall immediately notify the Commission by telegram, promptly confirmed in writing, of the net working capital of such dealer at the close of each such business day.

§ 32.11 Maintenance of books and records.

Each commodity option dealer shall keep such books and records as are necessary to make and record daily the net working capital computation required by this Part, the daily statement of the computation thereof and such other books and records as may be necessary or appropriate, in accordance with prudent business practice, in each case sufficient to enable the Commission to examine the records of all financial aspects of each and every commodity option transaction entered into by the dealer.

§ 32.12 Unlawful representations.

It shall be unlawful for any commodity option dealer or any affiliated person thereof expressly or impliedly to represent that the Commission, by declaring effective the registration of the commodity option dealer or otherwise, has directly or indirectly approved any dealer, or any commodity option transaction offered, entered into, or confirmed by a dealer.

§ 32.13 Fraud in connection with commodity option transactions.

It shall be unlawful for any person directly or indirectly,

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) To make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

(c) To deceive or attempt to deceive any other person by any means whatsoever;

in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction.

Written and Oral Submissions

Interested persons are invited to submit their comments on the proposed rules in writing to the Commission, 1120 Connecticut Avenue NW., Washington, D.C. 20036, Attention CCU. All submissions received prior to March 31, 1976, will be considered by the Commission in determining whether to revise of modify the proposed rules. In addition, the Commission has determined that an oral hearing on the subject and commodity option transactions in general, and on the standards imposed by the proposed rules in particular, would be of value in determining whether the proposed rules should be modified. Accordingly, the Commission will hold oral hearings to commence at 10:00 a.m. on March 8, 1976, in Washington, D.C. at a location to be announced. Persons interested in participating at the Commission's hearing should contact Ms. Jane Stuckey, Director, Office of the Secretariat, Commodity Futures Trading Commission, 1120 Connecticut Avenue NW., Washington, D.C. 20036, (202) 254-6314, before March 1, 1976. Comments already received and received in response to the Commission's announcement today will be made part of this proceeding. In addition, persons wishing to appear and make an oral presentation at the Commission hearing should forward a copy of their proposed statement to Ms. Stuckey by March 1, 1976. Oral presentations will be limited to 15 minutes and the Commission and its staff may question commentators at the conclusion of their prepared state-

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EXHIBIT "B" TO AFFIDAVIT OF JOHN FORM

Charles J. Hecht
COUNSELOR AT LAW
60 East 42nd Street
New York, N.Y. 10017

Telephone (212) 490-3232

Suite 1750

March 10, 1976

Options Subcommittee
The Commodity Futures Trading Commission
1120 Connecticut Avenue
Washington, D.C.

Re: Proposed Regulations of Commodity Option Transactions

Gentlemen:

Pursuant to the authorization of John V. Rainbolt, II, Vice Chairman of the Commodities Futures Trading Commission (the "CFTC") and Chairman of the Options Subcommittee of the Advisory Committee on the Definition and Regulation of Market Investments given at the public hearing of March 8, 1976 submitted herewith are my written comments with respect to proposed Regulations of Commodity Option Transactions initially published in the Federal Register on February 20, 1976. These written comments reflect the oral testimony furnished by me as counsel to British American Commodities Option Corporation ("British American"), which deals exclusively in so-called London Options, and the inquiries of the members of the Subcommittee.

Under separate cover I am furnishing certain information requested by Commissioner Read P. Dunn relating to the extent of the specific operations of my client and respectfully request that such supplemental information be granted confidential treatment pending the time such information would be required in any application filed by British American to become registered as a commodity options dealer.

General

To properly understand the comments with respect to the proposed regulations I believe it would be appropriate to describe the nature of my clients business so that various apparent misunderstandings by certain members of the staff can be eliminated.

The sale of options to purchase or sell commodities, as distinguished from the purchase or sale of the actual futures commodity contract, is a very new business in the United States and from all indications is receiving increased interest from the investment community. The apparent reason for the increased interest in commodities options is that unlike the purchase of futures commodity contracts on margin the investor's risk of loss is limited to the purchase price of the option. Accordingly, he is not concerned with substantial margin calls in the event that the price of the commodity should sharply move away from the striking price in value and, as is often the case, the margin call far exceeds the amount of his original investment.

The popularity of the so-called London Option is based upon the fact that the International Commodities Clearing House, Ltd. (the "ICCH") located in London, Great Britain now make available registered options. British American is principally engaged in the sale of soft options which are sold by or through a clearing member of the ICCH and upon sale both the option and, where applicable, the underlying futures contract, are registered on the books of ICCH in the name of the clearing members of the ICCH who are on both sides of the transaction. As an additional safeguard the confirmation slip furnished to the customer of British American and the confirmation slip running from Shearson Hayden Stone & Co., the executing broker-dealer, contain the identical number so that if anything should happen to British American or Shearson the customer's option may be traced. At the present time it is my understanding that a similar option is not available through any American trading market or contract market.

The proposed regulations require that a trading market must be registered with the CFTC. Without delving into the jurisdictional question of whether or not the CFTC has jurisdiction over such exchanges, it should be pointed out at a minimum that the proposed regulations have a substantial economic impact on one of our principal allies. Accordingly, on March 5, 1976 I forwarded a copy of the proposed regulations and the accompanying staff explanation of the same to the ICCH and respectively urge the Subcommittee to delay the adoption of any rules until comments are received by the ICCH. In view of the substantial prior history of the ICCH and its stringent financial requirements consideration should be given to amending the proposed regulations so as to include such exchange within the definition of a trading market.(1)

The mechanics of a London Option are as follows:

A. Initially a clearing member or members of the ICCH will furnish quotations with respect to put or call options relating to a specific futures contract.

B. Based on such quotation and the commissions payable by British American to its executing broker, British American will then set a price for the option, which will include its commission for obtaining the transaction.* There are a number of other dealers in so-called commodity options and the investor is free to check with such other dealers to obtain the best price for a particular option.

C. Upon receipt of the customers funds British American then places an order with Shearson Hayden Stone & Co., which is a member of the ICCH who in turn executes the order. Shearson promptly transmits the funds received by it, less its commission to the ICCH.(2)

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(1) To date British American has sold a limited number of options through the London Metals Exchange, which is an association of 33 dealers, including Shearson, where each broker-member must guarantee a portion and put up a substantial bond. However, they have not as yet established a similar clearing mechanism to that of the ICCH for options.

* The customer is advised that this is an open market order and is initially furnished an open order notice. Upon receipt of the customer's funds the order is submitted for execution and the striking price is set and confirmed to the customer in writing.

D. The ICCH then registers the option and, where appropriate, the underlying futures contract on its books setting forth the date and time of execution, the expiration date and the commodity and the names of the broker on both sides of the transaction. Furthermore, the clearing member through whom the option is initially sold must leave the premium intact until the option expires or is closed out.

E. After execution of the option order the clearing member through whom the option is written is required at the close of each business day to mark to current market value all of the open transactions on its books, which would include any options transacted by it through British American and subsequently executed by Shearson. Under the ICCH By-Laws the clearing house guarantees fulfillment of each futures option.

Section 32.2
(Minimum net working capital requirements of $100,000)

The proposed regulations fail to make a basic distinction between a commodity option dealer who acts solely as agent for the sale of commodity options and the commodity option dealer who trades for his own account or trades with or against his customers. In the latter situation a substantial net working capital would be required so that the owner of a call option would be protected in the event that the market value of the underlying commodity contract should increase substantially and, thus, when and if he exercises such option there will be sufficient capital so that the option can be exercised.(3) However as to the former no such substantial net working capital requirement seems justified. The members of the Subcommittee took the position that the premiums should be guaranteed through the dealer who sells the option. It is this writer's opinion that this approach is incorrect. Once the premium is paid it is the property of the writer of the option to be disposed of as such writer deems fit. However, under the ICCH procedure such premium must be left intact until the option expires or is closed out. The real concern should be that the beneficial owners of the options are in a position to exercise such options if they so desire. Accordingly, the principal financial obligation in the transactual chain is that of the clearing member of the ICCH through whom the option is written and since such member is required to mark to current market all open transactions on a daily basis adequate protection is afforded to the beneficial owners of the options.

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(2) In short the option price paid by the investor has three distinct elements (i) the premium payable to the option writer, (ii) the commission payable to Shearson Hayden Stone & Co. and (iii) the commission payable to British American.

The proposed regulations overlook the foregoing basic distinctions and it is respectfully submitted that so long as the commodity option dealer does not own a beneficial interest in any underlying commodity contracts or in any hedge options a far less minimum net working capital is required. Nor should such dealers be required to make adjustments to net working capital to reflect current market values in the underlying commodity futures contracts since the clearing member of the ICCH is required to take the necessary steps to insure that the option can be covered.

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(3) As to a put option the beneficial owner will want protection if the market price of the underlying commodity should decline substantially.

In this connection, it is respectfully submitted that this type of commodity option dealer is analagous to a securities broker dealer who clears through another brokerage house. Under Rule 15 c3-1(a)(3) of the rules and regulations promulgated under the Securities and Exchange Act of 1934, as amended, such a securities dealer would only be required to maintain a net capital of not less than $5,000 and under certain circumstances, such requirement would be reduced to $2,500. In both that situation and the instant situation, both types of dealers promptly transmit customers funds and securities received in connection with their activities and do not otherwise owe funds or securities for, or owe money or securities to, customers. Nor do they sell on margin. Therefore consideration should be given to reducing the minimum net working capital requirement to $25,000 to $40,000. As presently proposed, not even my client, which believes it is the largest commodity option dealer, could comply with the operational aspects of the net working capital rule. In effect, it would "regulate-out" any and all firms who intend to engage solely in commodity options without any economic justification other than having only the large brokerage houses who have a vested interest in selling commodities futures contracts on margin and have not offered such an investment vehicle to its customers. The principal concern of both the CFTC and my client is that protection should be afforded to the customers who have purchased the options in the event that the commodity options dealer is unable to continue its business either temporarily or permanently. As a practical matter, because of the recent vintage of this investment technique, existing bankruptcy laws do not appear to afford adequate protection to such persons in the event of the foregoing hypothetical situation. (See the United Kingdom Trading Corp. litigation where prompt action was not taken to protect the beneficial owners of the options.) Since it will take some time until the bankruptcy courts obtain the necessary knowledge of this type of transaction and the need for prompt action, the minimum net working capital of a registered commodities options dealer should exceed the minimum net capital of the type of securities dealer described above. Under the federal securities laws this problem has been handled by the use of the Securities Investors Protection Corporation.

In view of the limited number of commodity option dealers, consideration should be given to coordinate with SIPIC rather than setting up another layer of regulation. Another consideration should be proper reporting requirements to the CFTC so that when a registered commodity options dealer appears to be approaching financial difficulties its activities are automatically suspended. The proposed regulations appear to offer a viable solution with respect to this alternative. However, it is respectfully suggested that an additional provision be added which permits the CFTC to promptly obtain all confirmation slips and other data relating to the current position of the commodity options dealer and with his executing brokers to facilitate the closing out of profitable options transactions prior to the expiration date of those options. Furthermore, as both industry and the CFTC become more familiar with commodity options alternative approaches, which as of yet are unknown, may be more suitable.

Comments with respect to specific aspects of Section 32.10 are being prepared by the accounting firm of Katz, Zuckerman & Co.

Sections 32.5(4)(5) and (6)

As presently drafted, it is this writer's belief that the above requirement violates various provisions of both state and federal law. There is a basic distinction between the regulation of a commodities option dealer and the concept of doing business within a state. The former is exclusively within the jurisdiction of the CFTC with certain potential exceptions where the SEC contends they have jurisdiction. *Clayton Brokerage Co. of St. Louis* v. *Roy M. Mauer* (CCH Fed. Comm. Fut. L. Rep. ¶20,128 (Sup. Ct., Texas, Dec. 17, 1975). The concept of doing business within a state so as to subject someone to jurisdiction for purposes of being subject to suit is solely a question of state law. The statutes and case law within the 50 states vary significantly as to "what is doing business" and should not be amended, repealed or modified by rules and regulations of a federal regulatory agency. It would also unnecessarily increase the costs of doing business an additional $8,000 to $10,000 per annum, which ultimately will be passed on to the consumer. To the extent the CFTC desires to coordinate with the various state regulatory agencies they have ample means within the respective agencies. In short, there is no economic or legal justification for imposing such additional costs of doing business or subjecting them unnecessarily to in personum jurisdiction. Accordingly, the application should only require such information as it relates to the principal and branch offices of the dealer. (Also applicable to Reg. 32.4(a).)

Section 32.5(7)(C) et seq.

As presently drafted, it is this writer's opinion that certain portions of sub-sections (C), (D), (E) and (F) are not permitted under the statutory language set forth in §4n(7)(B)(ii) in that there is a basic distinction between an administrative hearing and an order of permanent injunction by a Court of competent jurisdiction which is recognized by the statute and totally ignored in the proposed rule. The distinction is so basic that the practical effort of the proposed rule is to amend the statute without the necessary Congressional authorization. They are also inconsistent with the grounds for denial with respect to other categories of dealers or markets registered with the CFTC and clearly inconsistent with the phrase "for other good cause shown" as defined by the CFTC in 40 Federal Register 28-125-26 (1975).

It should also be pointed out that the proposed regulations are based upon certain misconceptions with respect to administrative proceedings, and, in particular, administrative proceedings before the SEC. It has been this writer's experience that where a consent order is entered into before the SEC, it specifically provides that the consent is solely for the purpose of that proceeding and is made without admitting or denying the allegations contained in the order of proceedings. Thus, the proposed regulations give a retroactive punitive effect to something which was not contemplated by the respondent at the time he entered into such a consent agreement with another regulatory agency. It would also have the additional defect of discouraging settlements in other proceedings instituted by other regulatory agencies because of the potential effect of such consent if such person or company desires to become registered as a commodities option dealer or an affiliate thereof.

Subsection G should also be deleted since it is contrary to the basic underlying statutory purpose of the federal bankruptcy laws, which is rehabilitation of debtors. As a potential basis for denial of registration and/or holding up the applicant to stigma based on the general public's failure to comprehend the bankruptcy laws, such a regulation is improper on its face. In addition, as presently drafted, it would cover all persons who may have been employed by a company which went into bankruptcy. Finally, there does not appear to be any statutory authorization for this regulation. See §4n(7)(3)(ii).

Section 32.6(c)

In view of the provisions of Section 32.7 relating to amendments to applications, the requirement for annual registration of a commodities option dealer is redundant both as to the industry and the CFTC.

Section 32.7(a)

The word "material" should be inserted to qualify the phrases "change of circumstances" and "change in promotional material". Otherwise the CFTC will be inundated with supplemental filings. Similarly the phrase "change in status" wherein the dealer is offering or proposes to offer commodity option transactions" should be deleted for the reasons set forth under the heading Sections 32.5(4)(5) and (6) on pages 7 and 8.

Section 32.8

It should be made clear in the regulation that it is improper for a commodity option dealer to guarantee a profit or a specific rate of return. Furthermore, as presently drafted, the proposed regulation would require such detail that it would be confusing and meaningless to the average person who desires to come to Washington to inspect the file. In addition, most of the requirements set forth herein are inapplicable to a company which operates in the manner of

British American. Thus, assuming arguendo, that a commodity option dealer should cease doing business while his clients' options are outstanding, the records of such dealer would be utilized by the trustee to coordinate with the executing broker to facilitate the exercise of options at the time so directed by the customer. British American receives a daily run from Shearson Hayden setting forth the position of its customers.

With respect to subparagraph (e) this is analagous to the situation where a broker sells over-the-counter stock as principal to his client and the amount of profit to the broker is never disclosed. Furthermore, the ultimate price of the option to the customer is competitive amongst various dealers and thus if dealer A is offering an identical option at a lower price than dealer B, the customer will purchase these options from dealer A. Due to the relative novelty of commodity options, at the present time newspapers do not publish quotations as to the purchase price of such options. However, as both the financial community and the newspaper community become more familiar with this investment medium, I am confident that newspaper advertisements and ultimately newspaper quotations will be an every day occurrence. The same comments are also applicable to subparagraphs (l) and (m). In addition, the purchase of options is completely different than the purchase of unregulated commodities on margin and thus the financial risk of the purchaser of an option is limited to the purchase price of that option. The risks of investment relate to the price fluctuation of the underlying commodity covered by the contract against which the option is sold.

In view of the current status of the federal bankruptcy laws vis-a-vis commodity options, the requirements set forth in subparagraphs (j) and (p) are inherently unfair and improper. Moreover, as presently drafted subparagraph (p) is too vague and all encompassing. Subparagraph (q) should include the qualifying phrase "in accordance with these regulations" at the end. Otherwise, it could place registrants in unfair positions and subject them to unwarranted and unduly burdensome requirements.

Section 32.9

Since the regulations are designed for implementing rules as to the operations of a dealer and not the registration of the options or underlying futures contract, the provisions relating to the contracts and reports furnished to reflect such distinction.

Section 32.10

It should be made clear that the net capital computation of the dealer relates only to options beneficially owned by that dealer. If not, the computations relating thereto do not make any sense. The more options a dealer sells and the better his customers do, the greater the charge to net working capital. It would also impose an impossible accounting burden on the broker-dealer which would only be warranted with respect to options beneficially owned by him. See discussions relating to proposed Regulation 32.2 (supra).

Section 32.13

As presently drafted Section 32.13(b) of the proposed regulations represents an unauthorized amendment to the general anti-fraud provision set forth in Section 4(o) of the Act. It also conflicts with the basic anti-fraud statutes and rules under the federal securities laws. Such subparagraph is apparently derived from Rule 10b-5(2) promulgated under the Securities Exchange Act of 1934, as amended. However, unlike Rule 10b-5(2) there is no qualifying provision such as "in the light of the circumstances under which they were made" to the term "false report or statement". Furthermore, there is no qualification as to "materiality" in this subparagraph of the proposed rule.

Accordingly, this proposed rule could be deemed to impose strict liability without any relationship to the surrounding circumstances or the materiality of such allegedly false and misleading reports or statements. The implications of this as to the scope of the CFTC's regulatory powers and the potential civil liability of commodity option dealers is so important that any such change should be accomplished by Congressional enactment. Thus, under this proposed rule a commodity option dealer would be civilly liable to its customers for allegedly false and misleading statements or reports even where such statements were not material or the customer did not rely upon such allegedly false and misleading statements. This is contrary to the present state of the law under Rule 10b-5. See *Rochez Bros., Inc.* v. *Rhoades* 491 F.2d 402 (3rd Cir. 1974); *Carras* v. *Burns* 516 F.2d 251 (4th Cir. 1975) and *Chelsea Associates* v. *Rapanos* CCH Fed. Sec. L. Rep. ¶95,374 (6th Cir. 1975). It is respectfully submitted that the proposed Section 32.13 be revised to be consistent with Section 4(o) of the Act and that the law in this area be developed by administrative and judicial decisions relating to specific factual situations.

The foregoing represent my preliminary comments with respect to the proposed regulations. In view of the above, the written comments and testimony of other interested parties and the fact that these proposed regulations were first published for comment on February 20, 1976, I respectfully request that these regulations not be adopted either on an interim or permanent basis until further consideration by the Advisory Committee. If you have any questions with respect to the foregoing, please feel free to contact me.

Respectfully submitted,

Charles J. Hecht

Charles J. Hecht

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EXHIBIT "C" TO AFFIDAVIT OF JOHN FORMA

CCH

Commodity Futures

LAW REPORTS

NUMBER 26 JULY 15, 1976

EXTRA EDITION

RECOMMENDED POLICIES ON COMMODITY OPTION TRANSACTIONS

Report of the Advisory Committee
on the
Definition and Regulation of Market Instruments
to the
Commodity Futures Trading Commission

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About This Report

This Special Report contains the final recommendations of the CFTC Advisory Committee on the Definition and Regulation of Market Instruments regarding commodity option transactions.

The Commodity Futures Trading Commission Act of 1974 authorized the new federal regulatory agency to determine whether options trading in previously unregulated commodities should be permitted in the United States, and, if so, under what regulatory terms and conditions.

In order to obtain the broadest range of input on this and other important issues, the CFTC established four advisory committees in October, 1975, made up of futures industry, governmental and public members.

The Advisory Committee on the Definition and Regulation of Market Instruments, which has recommended that commodity options trading should not be banned and suggested mechanisms for regulating such trading, has submitted this report to the Commission to serve as a guide in the ultimate determination of the economic questions posed by the Congress.

July, 1976

COMMERCE CLEARING HOUSE, INC.

MEMBERSHIP
OF THE
ADVISORY COMMITTEE ON
DEFINITION AND REGULATION OF MARKET INSTRUMENTS

Honorable John V. Rainbolt, II, Chairman*
Vice Chairman
Commodity Futures Trading Commission

William T. Bagley**	Chairman Commodity Futures Trading Commission
Paul H. Franklin	Director, Commodities Division Merrill Lynch, Pierce, Fenner & Smith, Inc.
Billy Ray Gowdy	Farmer/Rancher
Dr. Roger W. Gray	Professor and Economist Food Research Institute Stanford University
Joseph B. Gregg	Partner Morrision-Gregg-Mitchell Grain Company
Sam Israel, Jr.	International Commodity Merchant ACLI International, Inc.
Dr. Henry G. Jarecki	Chairman Mocatta Metals Corporation
Philip F. Johnson, Esq.	Partner Kirkland and Ellis
Rodney E. Leonard	Executive Director Community Nutrition Institute
Leo Melamed	Chairman of the Board International Monetary Market of the Chicago Mercantile Exchange, Inc.
John M. Mount	Vice President and Director of Purchasing The Coca-Cola Company
Philip C. Olsson, Esq.	Partner Collier, Shannon, Rill and Edwards
M. Martin Rom	Rom - Geltner Companies, Inc.

*Chairman Rainbolt presided over the meetings of the Advisory Committee and the Subcommittee on Commodity Options and participated in their discussions, but did not cast a vote on any issues relating to these recommendations.

**Ex Officio (non-voting).

Edmund R. Schroeder, Esq.	Partner Barrett, Smith, Schapiro & Simon
Stephen F. Selig, Esq.	Partner Baer & Marks
Donald B. Walker	Vice Chairman Archer, Daniels, Midland Company
David Hart Wunder	Securities Commissioner State of Illinois

Edward J. Nowicki, Jr., Director

Staff

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Charles E. Hord, III, Esq.
Joan L. Loizeaux, Esq.
Dr. Russell F. McDonald
Dru E. Mc Elhannon
John R. Mielke
Pat G. Nicolette, Esq.
Fred M. Santo, Esq.
Gregory G. Walker, Esq.
Carol A. Weber

SUBCOMMITTEE ON COMMODITY OPTIONS

Paul H. Franklin
Dr. Roger W. Gray
Sam Israel, Jr.
Dr. Henry G. Jarecki
John M. Mount
Edmund R. Schroeder, Esq.
Stephen F. Selig, Esq.

Staff

Gregory G. Walker, Counsel

Terry L. Claassen, Esq.
Lloyd E. Friesen, Esq.
Joan L. Loizeaux, Esq.
Dru E. Mc Elhannon
John R. Mielke
Pat G. Nicolette, Esq.
Fred M. Santo, Esq.
Carol A. Weber

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

July 6, 1976

Honorable William T. Bagley
Chairman
Commodity Futures Trading Commission
Washington, D.C. 20581

Dear Mr. Chairman:

Attached herewith is the report and recommendations of the Advisory Committee on Market Instruments regarding a policy on commodity option trading. At the request of other members of the Commission, I have provided some separate thoughts on use of the study as a Foreword to the report.

This is the first of three reports from the Advisory Committee. The recommendations with respect to leverage contracts and cash market surveillance and data needs are to follow shortly.

I would like to schedule discussion of the report before an extended session of the Commission in the near future. I feel the situation with respect to commodity options demands early regulations to deal with the ongoing problem of offerings here under circumstances of which we have all become too painfully aware. Also, this is the first report formally transmitted to the Commission by one of the four Advisory Committees chartered by the Commission and I feel that it is important that we act realistically upon these recommendations in as expeditious a manner as possible. Other important and complex recommendations will no doubt follow from other committees.

I am proud to have been associated with the members of the Committee and impressed by the extremely capable work provided by Commission staff members who supported the

Committee in this task. All are to be commended. To my knowledge, the study is the most comprehensive study of commodity option policy yet made.

Sincerely,

John V. Rainbolt, II
Vice-Chairman and
Chairman of the Advisory Committee
on Definition and Regulation
of Market Instruments

cc: The Commission

FOREWORD

Ever since the State of Illinois first banned trading in "privileges" in 1874, no problem of the commodity trading community has been more troublesome than attempts by government and exchanges to find a policy to deal realistically with the trading of commodity options. For the last 100 years, exchanges, state legislatures and the federal government have engaged almost continually in what has amounted to a ponderous regulatory waltz with options and their immediate exchange ancestors, "privileges" and "indemnities."

The Commodity Exchange Act bans the trading of "options", "privileges", "indemnities", "puts", and "calls" on commodities regulated prior to the passage of the Commodity Futures Trading Commission Act of 1974. However, prior to April 21, 1975, (the effective date of the Act) all commodities unregulated by the federal government were and remain eligible for option trading.

The public's growing fascination with options, coupled with inadequate customer protections, has resulted in substantial losses for unsophisticated persons, the prime example being the Goldstein-Samuelson scandal, where customers reportedly lost over $70 million by investing in a commodity option scheme "pyramided" by its developers.

Yet the desire -- some say the allure -- of option trading remains. Although few seriously dispute the danger of unregulated option trading, arguments are advanced that such trading, carefully regulated and carefully monitored, can enhance risk-shifting activities by commercial users, supply new market information, and provide a more attractive investment vehicle for some speculators than commodity futures trading. A split of opinion therefore exists: those who find options to be against the public interest and others who defend option trading as serving a useful, publicly acceptable economic purpose.

Faced with this dichotomy of opinion at the time of writing the Commodity Futures Trading Commission Act of 1974, Congress placed the burden for determining whether commodity option trading should be allowed-- and if so, under what terms and circumstances -- with the Commodity Futures Trading Commission. The study presented here recommends a course of action for the Commission to follow with respect to option trading. While it is not, and was not intended to be, the "ultimate" study on the subject (which must, of necessity, await more definitive data), its undertaking was suggested as an initial step in dealing with the issues posed by Section 4c(b) of the Commodity Exchange Act.

The Commission determined that the assistance of an Advisory Committee would be helpful to provide input to the Commission's decision-making process on the option question. Accordingly, it directed the Advisory Committee on Definition and Regulation of Market Instruments to provide initial recommendations to the Commission for its consideration. Chartered in October 1975, the Advisory Committee -- which also studied leverage contracts, Commission cash market regulatory authority and the Commission's cash market data needs and resources -- had thirty-four meetings, including two public hearings in Los Angeles and Washington, D. C. Three subcommittees were constituted from among the members of the Advisory Committee. These subcommittees made initial recommendations on the issues which were then considered by the full Advisory Committee en banc. One of those subcommittees was devoted to the study of commodity options. A majority of the Advisory Committee's meetings was devoted to consideration of the options issue by the seven-member Options Subcommittee; near the end of their deliberations, members of the Committee, and particularly members of the Options Subcommittee, contributed as much as two days of their time every two weeks to the study. On balance, the performance of the Advisory Committee was one of the most impressive displays of selfless dedication to better government with which I have had the honor to be associated.

The Committee was composed originally of seventeen members from many walks of life. Representing both public and private interests, the Committee included various industry leaders, exchange officials, economists, attorneys, a state securities commissioner, a farmer-rancher, and a consumer representative. Initially, some of these persons favored commodity option trading, while others were opposed to it. Another member of the Commission, Chairman William T. Bagley, was an ex officio member.

The Advisory Committee was constrained by limitations of time, staffing and budget. Nevertheless, it moved swiftly to adopt recommendations on commodity option trading which represent a clear consensus of the Committee's thinking. This is not to say that the construction of the report or the recommendations stated therein were arrived at without controversy. Numerous discussions and debates took place during the course of the meetings, during which various members' perceptions of the issues at hand fluctuated. Several points were raised, discussed, and abandoned, only to be raised again at a later date as a fuller recognition of the implications of certain issues became apparent from another perspective. As a result of the dedication and hard work displayed by the members and staff of the Committee, the final report is now available.

Forms of Option Trading

The Committee approached the concept of commodity options by dealing separately with options traded (or sold, depending on the circumstances) on and off contract markets, further distinguishing between "assignable" and "non-assignable" options. An "assignable" option is one where the holder of the option may convey his rights to a third party in what might constitute a secondary market. The Committee found that such options, with few exceptions, could pose a threat to the regulatory structure envisioned. In the case of a contract market option, for example, it is the Committee's belief that the creation of a secondary market might have a negative impact in terms of supervisability and might also create liquidity problems.

Conceptually, contract market options may be either transferable or non-transferable. The former envisions a trading forum where one option is offset against another in much the same manner as futures contracts are currently traded. A non-transferable option may not be offset and can only be liquidated through exercise or expiration.

As in the contract market option area, off-contract market options may be either assignable or non-assignable and transferable or non-transferable. Off-contract market options fall into two classes: domestic dealer options and foreign options. Either option may be further subdivided into options on futures contracts and options on physical commodities. The Committee, in Recommendation 4(a) at p. 37 of the Report, recommended banning domestic dealer options on futures, equating them with the Goldstein-Samuelson debacle. (Reportedly, Goldstein and Samuelson were offering options on futures contracts traded on an unregulated exchange.) This recommendation preserves the symmetry of the report and has little substantive impact since by law in the United States all futures contracts must now be traded on exchanges designated by the Commission as contract markets and regulated under the Commodity Exchange Act.

However, the Committee recommended that assignable dealer options on physical commodities should not be prohibited so long as three basic protections, or their equivalents, afforded futures customers on contract markets are available, i.e., segregation of funds, a mechanism guaranteeing performance of the transaction and adequate supervision and control of trading practices and activities. In the case of a dealer option on physicals, the assignability issue is particularly important since non-assignability might create a system where the individual purchasing the option has no recourse but to go back to the offering dealer to get out of his contract.

Foreign options include London exchange options cleared through the International Commodities Clearing House ("ICCH") and the options backed by the individual members of the London Metals Exchange. These options can be, and usually are, offered through the auspices of a dealer in this country

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to the final customer. Also included in the foreign option area would be the offerings of other foreign entities to United States citizens -- for example, a Swiss bank offering an option on gold bullion.

As a matter of semantics, ICCH options may also be described as non-transferable "exchange" options because they are written on futures contracts traded on a terminal market of the London Commodity Exchange which clears through the ICCH with no right of offset -- a reminder of the tricky semantics of the options world.

Non-transferable exchange options are probably the best known class of foreign option domestically offered today due to the popularity of the ICCH mechanism. As in the case of the Committee's recommendations with respect to domestic dealer options, the Committee would not prohibit domestic offerings of foreign options if the three customer protections mentioned above, or their equivalents, are available.

Another question which confronted the Committee with regard to options both on and off contract markets was the question of paid-in-full versus "margined" premiums.

The Advisory Committee's recommendation with respect to margining option premiums on contract markets is that contract markets and FCMs should be permitted to determine the extent, if any, to which such premiums may be margined by customers. The Committee concluded that the margining of premiums would be feasible where (1) the original margin on the premium is at least equal to the original margin on the underlying futures contract, and (2) options are "marked-to-market" each day by the contract market or its clearing organization and calls for additional margin are made promptly to customers (up to the full premium cost) when adverse market movements occur.

Similarly, in the case of options off-contract markets, the Advisory Committee felt that margining of premiums should not be permitted at levels which would adversely affect the futures markets. In addition, the Advisory Committee cautioned the Commission to watch closely the development of the "margin concept" and its subsequent use.

The concern of opponents of margining was fear that trading in such options would ultimately detract from the liquidity of the underlying futures contract since the option could, perhaps, be offered "cheaper" than a futures contract.

The distinctions between "assignability" and "non-assignability" and "transferability" and "non-transferability" and the issue of margining premiums are important in that they relate both to the supervisability of the structure the Committee envisioned for option trading and the competitive ability of the options traded. It was noted, for example, in the contract market context that a transferable option with a margined premium would probably prove to be the most attractive form of option trading to speculators because of the ease of offset and the possibility of entering into the transaction with a limited capital outlay.

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The Advisory Committee Process

While the members of the Committee -- and particularly the members of its Options Subcommittee -- worked diligently to produce a comprehensive document on commodity option policy, there are limits to the use of the Advisory Committee forum itself, especially in an area as complex as commodity option trading, where the lack of needed data regarding the subject hampered the Advisory Committee's inquiries.

There are certain other issues raised by the use of Advisory Committees in government, particularly with respect to its regulatory function. One is the broad question of the public's perception of the Committee's membership; another is the Commission's use of the report. Although the Committee was constructed in such a way as to provide maximum expertise and balance, the fact remains that to obtain that expertise, there were more people from "industry" than those purporting to be from the "public", although the vast preponderance of members were not from the option industry *per se*. There is, therefore, a delicate question of "industry" influence in the Advisory Committee process that has to be acknowledged. Once acknowledged, however, this report provides sound information and policy recommendations upon which the Commission's independent assessments can be made.

Scope of the Report

The Committee sought to develop a study and recommendations that not only would encompass the immediately perceivable problems in the option world, such as "London" options, domestic dealer options, and proposed option contracts on futures exchanges, but would also identify other conceivable types of option trading that might take place -- e.g., options on physicals on exchanges.

In itself, this, while necessary, was troublesome. Read literally, the word "options" in the Commodity Exchange Act may include not only the class of option transactions which have been a regulatory and market problem in the past and which were the primary concern of Congress in adopting Section 4c(b) of the Act, but also options among commercial interests in the normal course of commerce which are not offered to the public. The Committee believed that, except for application of antifraud rules, these commercial types of option transactions should not be the subject of Commission concern, and the Committee attempted to deal with the problem by adopting the "trade option exemption" language appearing in recommendation 4(b) at page 38 of the report. I concur that such an exemption for option transactions among trade professionals is appropriate. However, the exemption proposed is complex and should be examined carefully by the Commission to make sure that persons intended to have the benefits of the Commission's general regulations concerning option trading are not precluded therefrom.

Also, from the Commission's viewpoint, regulating "options," particularly in light of the definition of "commodity" contained in Section 2(a)(1) of the Act and the

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relatively untested cash market jurisdiction that seems to flow from other provisions of the law,* may result in a perceived jurisdictional grant that, while perhaps "legalistically" correct, is not a product of "common sense". Again, the Committee partially dealt with this problem by adopting the "trade option exemption" language embodied in recommendation 4(b), referred to above.

* * * * * *

While I am favorably impressed with the answers provided by the Committee to the burdensome question of commodity options, I also have some separate thoughts by way of emphasis and some reflections on the Commission's use and implementation of the Committee's recommendations.

In that spirit, I offer some comments on the findings of the Committee that option trading should not be prohibited and why; its findings with respect to contract market options; and its recommendatons regarding off-contract market options:

Commodity Options in the U.S.: What Test?

The most important finding of the Committee is the determination that option trading in general, should not be banned. The potential use of options to commercial hedgers, plus the advantage of having an instrument which reflects the best judgment of the market as to expected price volatility, can provide positive benefits to the economy.

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*See the Advisory Committee's report on the Commission's cash market jurisdiction.

However, the Commission may wish to reflect before accepting the reasons accompanying the recommendations dealing with the approval of a domestic commodity option market. The rationale at page 15 of the report reads:

> The committee is strongly of the view that it is not necessary to demonstrate an improvement or a betterment of the public interest in order to permit option trading, anymore than it is necessary to establish an affirmative justification for engaging in any other form of economic activity. Rather, it should simply be required that the public interest will not be so adversely affected by such trading that there is sufficient reason to prohibit it.

Perhaps, the above statement is economically enlightened. However, it is probably not the test that Congress and the public expect the Commission to apply in dealing with the commodity option question, particularly on contract markets.

In the face of the statutory bar to option trading on the "previously regulated" commodities, more will be expected from the Commission than that it cavalierly approve behavior that carries an immediate history of customer protection problems and a longer history of creating problems for the self-regulatory process of domestic exchange markets.

An option on a futures contract is essentially an interest in that contract and thus affects the community using the markets, including its hedging users, speculators, and also the general public, which the markets should ultimately serve.

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It has been suggested that the Commission apply the same test for [illegible]ons that it applies for futures contracts, i.e., that "they not be contrary to the public interest," and proceed to interpret that test in line with the requirement promulgated by the Commission in Guideline No. 1 on May 13, 1975. In such case, the designation of an exchange or entity for option trading would depend on the probability that the option contract would find more than occasional use by hedging interests.

This concept, first written as an "economic purpose" test in the original version of H.R. 11955, the parent bill of the Commodity Futures Trading Commission Act of 1974, later evolved to become the "public interest" test for "transactions for future delivery" adopted by Congress in Section 5(g) of the Act. The Commission interpreted that test for futures contracts in Guideline No. 1.

Does the law envision a different "test" for options? The statute, itself, is silent. In the absence of statutory guidance, and in light of section 5(g), I suggest that the Commission require that proponents of option trading should be prepared to meet requirements and procedures similar to those required by the Commission for futures trading on contract markets which are designated by the Commission.

Data supplied to the Committee indicated that commodity options, in the words of the report at page 15, "have been and are being used by commercial and other interests in ways that are not contrary to the public interest." Pending a more definitive answer to the question of the volume of such use, the recommendation implies that option trading should be able to meet a test of use by commercial interests.

The desirability of applying such a test is enhanced by the difficulty of the Committee in projecting the economic impact of commodity options. Here, the report is not as strong as I would like, particularly with respect to indicating the anticipated effect of contract market option trading on underlying futures contracts. This, of course, was not the fault of the Committee, but a reflection of the Committee's difficulty within a limited time to obtain and construct enough data to project this effect. This lack of data does not necessarily invalidate the findings of the Committee with respect to the economic usefulness of option trading, or to its potential viability on exchanges, but it does provide a cautionary note, or if you will, a warning flag.

Observing such signals is part of the Commission's oversight role vis-a-vis options. Nowhere are they more important to Commission deliberations than in our decisions affecting contract market options.

Contract Market Options: A Pilot Program

Those who do not learn from history are doomed to repeat it. "Privileges" and "indemnities" were the bane of exchanges, legislatures, and successive secretaries of

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Agriculture. Similarly, their descendents, commodity options, have the capability of becoming the bane of the Commission, unless correctly handled.

Turning exclusively, for the moment, to option trading on contract markets, I have reservations about adopting all the recommendations and findings of the Committee appearing at pages 22-37 of the report without further study and testing. If adopted by the Commission without further thought, they could result in scrambling competition among the contract markets to attract customer premiums; and I do not feel that the industry or the Commission -- and much less the public -- wishes to be put in the position of attempting to survive such a "shakedown". There is also a possibility that option contracts developed through such a process may not necessarily be those most immediately commercially useful -- reason enough, I think, to call for constructive government participation in developing such contracts.

Again, the warning signals are there. Since the Advisory Committee has concluded its work, I have spent some time discussing contract market options with interested exchange groups and others in the industry. These meetings reveal that there is no uniform approach to commodity option trading within the industry at this time. They also reveal concern among some exchange leaders as to the ability of contract markets to handle certain forms of option trading which the Committee felt should not be prohibited. For example, there appears to be substantial concern over the idea of margining option premiums, the concern being that it would drain liquidity from the underlying futures markets and create substantial "back office" problems for FCMs and clearing problems for contract markets.

Transferability is also viewed with question in some quarters: one exchange options group felt that it would be required to install a completely separate clearing system to handle trading in transferable options.

While more familiarity with the Committee concepts may ease these concerns, there still may be questions as to the ability of various contract markets to handle certain types of option trading. The question remains as to whether all commodities on which options legally may be traded should be the subject of option trading. For example, could a futures market in a particular commodity be too "thin" to support option trading? The Committee felt not, but determined that further study is necessary.

While many of these issues were discussed by the Committee, and even debated hotly, the final recommendations with respect to transferability and margining of premiums on contract markets are essentially positive. While competition would ultimately settle the issue as to which type of contract market option is the superior market instrument, the suspicion remains that this concept, applied initially, may be sacrificing practicality.

As an attempt to resolve some or all of these issues, and to provide proponents of option trading an opportunity to

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demonstrate its usefulness to commercial hedgers, the Commission should initiate a pilot program for option trading on contract markets, working with appropriate sectors of the industry toward drafting an option contract that protects the markets and provides useful market information. This information and such other studies as the CFTC should choose to commission, could provide the basis for expanding domestic option markets if the initial testing period proves successful.

What should be the elements of such a program? At the outset, it should be designed to demonstrate that there are useful commercial possibilities for commodity options and that they can be safely traded and offered to the public.

The commodity(s) and contract market(s) selected should be capable of providing a useful experience that: (1) would be translatable to other commodities and other types of option trading, (2) potentially would be the most useful to hedgers, and (3) provide the greatest protection to the public and the markets.

A pilot program requires an adequate period for testing -- probably at least three years. During the testing period, the Commission should expect that initial "shakedown" problems on the option contract can be resolved and that whatever industrial interest exists in utilizing commodity options will have begun to emerge.

There may also be questions as to the contract markets selected to participate in such a pilot program (not just which, but how many), and some thought must be given to the

the competitive advantage that any contract market chosen would perhaps exercise over other contract markets.

Selection of the contract markets involved should be limited to those which have demonstrated the ability to comply with the rules and regulations promulgated by the Commission, including requirements of adequate surveillance. The strength of clearing mechanisms and, of course, the willingness to cooperate with the Commission in developing the contract should also be considered. Such contract markets should be required to provide adequate data to the public with respect to open option positions, volume of transactions and option prices. This will not only aid in developing experience for subsequent option programs, but also aid in insuring that the underlying futures markets will have an opportunity to assimilate option trading data and are not adversely affected by any unexpected exercise of outstanding options.

Options Off Contract Markets: A Value Judgment

Having adopted the idea of transferring the traditional safeguards inherent in futures trading to option trading on contract markets, the Committee approached the problem of options off contract markets. As the report indicates, the Committee considered the legislative history and langauge of the CFTC Act to determine whether the Congress intended to actually restrict option transactions to contract markets only. Notwithstanding legislative history to that effect, the Committee's view was that Congress was chiefly concerned with the

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financial integrity of the transactions rather than the actual environment in which they occur. Before discussing the Committee's recommendations in this area, a characterization of some issues not necessarily apparent in the language of the report may be useful.

There are essentially two major factors to be considered in developing a realistic commodity option policy: (1) protection of customers, the primary problem with current domestic offerings of commodity options, and (2) protection of underlying markets against manipulation or liquidity problems.

It was generally accepted by the Committee that the key to solving customer protection problems on options offered in this country was to move such options to organized exchanges designated by the Commission. Segregation of premiums, clearing mechanisms, government and exchange surveillance and auditing procedures and competitive execution of transactions would, it was generally felt, "clean up" the industry and solve the customer protection problem.

There are, however, other values against which the recommendation not to prohibit option trading off contract markets must also be measured. These include concerns as to the possible effect on contract markets of permitting option trading off contract markets and the anti-competitive effects of a recommendation which would declare that options offered to the public can only exist on a handful of contract markets designated by the Commission.

Also, with respect to foreign and dealer options, there were (and are) issues of banning in this country what amounts to a legitimate form of activity in the United Kingdom and the enforceability of such an action. The Committee also was hard pressed to find a valid basis for distinguishing between London options and domestic dealer options. Could this be construed as submerging a domestic interest while at the same time allowing a foreign offering? Grappling over these issues, as well as those described in the report, culminated in the recommendations on off-contract market options.

My personal perception is that contract market options with premiums arrived at in a competitive exchange atmosphere will be a superior market instrument to other types of options. Beyond such options will be a residuum of individual and dealer interests in (1) options on those commodities which are not traded on a contract market, (2) those situations where the contract market has shown no interest in constructing an options market, (3) those situations where the customer has a unique interest in the physical commodity itself without an attendant interest in utilizing the futures market and (4) those situations where the buyer prefers to utilize a foreign options contract.

In the case of options traded on established foreign markets, there was some reason to acknowledge (without completely approving) the status quo. The London community has been writing options for several decades and the ICCH, in

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particular, provides some of the same customer protections as domestic contract markets. However, major problems do exist with London options, not the least of which is the absence of segregation.

The Committee recommendations involve bringing all off-contract market options under a new two-tier system of regulation, requiring initial approval of the proposed option trading structure by the Commission and continuous compliance by dealers with specific rules covering their option trading activities.

The system is designed to approximate three aforementioned protections provided to futures customers on contract markets, i.e., segregation of funds, a mechanism guaranteeing performance of the transaction, and adequate supervision and control of trading practices. Sacrificed, perhaps, were competitive execution and the benefits associated with price disclosure through contract markets. Unlike the protections afforded persons trading on contract markets, equivalent protections to segregation, clearing mechanisms and exchange supervision would be permitted. For example, the Committee sees bank guarantees as a substitute for the first two standards and a Title III association or similar association as being able to fulfill the supervisability role. Presumably, account insurance for commodity customers, if it existed, would also be helpful in fulfilling the customer protection needs of off-contract market option markets.

If the Commission adopts this two-tier system, it should be prepared to be flexible in determining its "equivalent protection" aspects. Many problems may arise in determining such "equivalents."

For example, each dealer or foreign options network may want its own Title III regulatory association; if this occurs, how far is the Commission willing to go in encouraging more than one such association? Can there be other equivalents to the "equivalent" association? The concept of a Title III association means different things to different individuals. Reluctantly, there was insufficient time for the Advisory Committee to discuss the viewpoints of its members as to what they thought a Title III association should ultimately be.

Underpinning the recommended system for off-contract market option trading are individual dealer requirements concerning net capital, segregation of funds, disclosure of information and advertising and promotional literature. By and large, while there is some overlap within the system envisioned, these are excellent recommendations, and pending the final disposition of the other issues raised in the report, the dealer requirements should be promulgated immediately.

Conclusion

In dealing with the commodity option issue the Commission could find precedent in the statutory ban on options on the "previously regulated" commodities and, citing the various

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problems associated with options through the years, extend that ban to the "new" commodities brought under federal regulation by the CFTC Act. No doubt there are those who would approve such a ban and, admittedly, it would require considerably fewer Commission resources to police than would a regulatory system allowing option trading.

However, before we exercise a natural desire to look for simple solutions, such as banning options, the Commission should be mindful of the success of those who have used such solutions in the past. The authoritarian approach (i.e., banning one or another aspect of legitimate economic behavior) has not necessarily proven, in every case, to be the most successful or correct course when interpreted in the light of history. Properly enforced, with intelligent interpretation of the structure envisioned by the Committee for off-contract market option trading, the requirements recommended offer a positive plan that represents a substantial step forward from past governmental approaches regarding commodity option trading.

It is probably time to see if we can bring commodity options in from the cold. If applied through a designation process, and interpreted in light of the Commission's "public interest" test currently applied to futures contracts, and implemented initially in the form of a pilot program for exchange options, the Committee's recommendations for strict regulation should provide an adequate structure to support trading in a market instrument that, in one form or another, has been seeking the favor of commercial and speculative interests for over a hundred years.

John V. Rainbolt, II
July 6, 1976

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Rainbolt, II
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SUMMARY

As amended by the Commodity Futures Trading Commission Act of 1974 (the "CFTC Act"), the Commodity Exchange Act (the "Act"), empowers the Commission to determine whether option trading in commodities, other than those specifically enumerated in Section 2(a)(1) of the Act, should be allowed in the United States, and if so, under what terms and conditions. The Commission chartered the Advisory Committee on Definition and Regulation of Market Instruments (the "Advisory Committee") to make recommendations in this regard. The Advisory Committee, working through a seven-member subcommittee, sought to develop recommendations that not only would encompass the immediately perceivable problems in the option world, such as "London" options, domestic dealer options and proposed options on futures contracts on exchanges, but also identify other conceivable types of option trading which might evolve. Those recommendations are the subject of this report and may be summarized as follows:

1. All forms of option trading should not be prohibited. The Advisory Committee found that options have been and are being used legitimately in ways that are not contrary to the public interest and concluded that a sufficient case was not made for banning option trading in general. However, the Advisory Committee determined that certain forms of option trading should be prohibited because they may be (a) illegal and/or (b) contrary to the public interest in that they could have a material adverse economic effect on domestic futures markets or otherwise.

2. Domestic trading in options should not be prohibited:

(a) on contract markets, or

(b) off contract markets in the case of Domestic Dealer Options on physical commodities and Foreign Options,

provided that there has been a showing that three of the basic customer protections, or their equivalents, afforded futures customers on contract markets are available, *i.e.*, segregation of funds, a mechanism guaranteeing performance of the option, and adequate supervision and control of trading practices and activities. Once these protections or their equivalents are extended to these types of option transactions, option trading should be allowed, subject to specific regulatory requirements.

3. Option trading on contract markets.

The Advisory Committee's recommendations with respect to option trading on contract markets were limited to options on domestic futures contracts, since it doubted that option trading on physical commodities would be initiated in the near future. With respect to options on futures contracts, the Advisory Committee distinguished among "transferable", "non-transferable" and "assignable" options. A transferable option may be liquidated by an offsetting transaction; a non-transferable option may not be so liquidated. An assignable option may be liquidated by conveyance off the contract market.

3(a) Trading in "assignable" options on domestic futures contracts should be prohibited. The Advisory Committee was concerned that such trading may be in violation of the Act and may also result in the creation of a secondary market in contract market options which could adversely affect the exchanges' option markets and their ability to assure the three basic customer protections referred to in paragraph 2 above.

3(b) Trading in non-assignable options on domestic futures contracts should not be prohibited, whether the options are "transferable" or "non-transferable." The Advisory Committee concluded that there was insufficient evidence to indicate that trading in either transferable or non-transferable options on contract markets would be so inherently dangerous to the economic health of futures marekts or otherwise that either should be prohibited as such. However, the Advisory Committee suggested that, before the Commission approves any plan for option trading on a contract market, it should first examine, to the extent possible, what economic effects such trading would have on futures trading.

3(c) The Advisory Committee concluded that, in general, trading in options involving futures contracts on designated contract markets should be regulated in a similar fashion to futures contracts, subject to the following requirements:

(1) Persons engaged in soliciting or accepting orders for the purchase or sale of such options should register with the Commission as FCMs or "associated persons."

(2) All funds, excluding commissions, and other property received from customers (as well as any open customer trade equity) should be segregated in the same manner

as prescribed in Section 4d(2) of the Act for customers' funds and property in futures transactions.

(3) Present financial requirements imposed on FCMs should be amended to cover FCMs' option trading activities.

(4) The Commission should consider what additional financial reporting requirements should be imposed on FCMs to reflect their option trading activities.

(5) Contract market option premiums should be competitively determined by open outcry. The extent to which option premiums are margined should be determined by the contract market and FCMs involved, so long as (i) original margin is at least equal to the original margin on the underlying futures contract and (ii) options are "marked to market" daily.

(6) FCMs should make the same disclosure to customers with respect to these option transactions as they are required to make concerning futures transactions.

(7) The Commission should generally monitor advertising and promotional materials used by FCMs and others regarding cotract market options but should not endeavor to approve such materials. However, such materials must conform to specified standards. Commission standards and requirements for use of advertising and promotional literature by contract markets should be uniform for futures and option transactions.

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(8) Any know-your-customer rules imposed by the Commission on FCMs regarding their futures transactions should be extended to their option transactions

3(d) The Commission should consider requiring that the expiration date of any option contract precede the delivery period on the underlying futures contract by a sufficient period to minimize the potential for the exercise of options to contribute to congested conditions in the futures market.

3(e) Option trading on futures contracts should be limited to the contract market on which the underlying futures contract is traded, unless it can be demonstrated that the customer protections set forth in paragraph 2 above can be provided and that the proposal will not have a material adverse effect on such contract market.

4. Option trading off contract markets.

4(a) Trading off contract markets in options involving domestic futures contracts should be prohibited. The Advisory Committee expressed concern as to the legality of these transactions and also as to their potential adverse effect on the volume and liquidity of futures markets.

4(b) "Trade option" transactions should be exempt from Commission regulation, except for the Commission's general antifraud rule governing option transactions. The Advisory Committee concluded that dealings between trade professionals did not require specific regulatory safeguards.

4(c) If the Commission finds that the three basic customer protections or equivalents referred to in paragraph 2 above are provided, trading in Domestic Dealer Options and Foreign Options should be regulated in accordance with the following requirements:

(1) Dealers of such options should register with the Commission as option commission merchants (OCMs). If such persons are already registered as FCMs, no additional registration should be required, but compliance should be required with all other regulations applicable to OCMs. All "Associated Persons" of the OCM and its agents should register as well as the agents themselves.

(2) A working capital requirement and a minimum net worth requirement should be imposed on OCMs. The minimum figures established should take into account increases in the number of open option positions.

(3) Each day, OCMs should "mark to market" customers' open option positions and allocate physically for the account of customers having net equity positions, cash, cash equivalents or, in certain cases, the physical commodity which is the subject of the option transaction, equal to the customers' net equity positions.

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(4) OCMs should physically segregate (i) all monies, excluding commissions, and other property received from customers and (ii) all cash, cash equivalents, or physical commodities allocated to customers' accounts. These assets should be treated substantially in the same manner as futures contract "margin" is treated under section 4d(2) of the Act.

(5) OCMs should prepare and furnish such financial statements as the Commission shall from time to time prescribe. At the least, OCMs should file annual audited and quarterly unaudited statements. In the event the OCM falls below established financial standards, the Commission should have all available enforcement tools at its disposal to take prompt corrective measures.

(6) Prior to entering into an option transaction, an OCM should deliver to a prospective customer a basic disclosure document containing information about the OCM and its associates and its financial condition and identifying those persons having financial responsibility in the transaction. In addition to the basic disclosure document, an OCM should deliver a summary statement of the major aspects of the option transaction. OCMs also should file daily or weekly information with the Commission concerning market trading activity.

(7) In the case of Domestic Dealer Options, OCMs should be permitted to determine option premiums and any markups thereon. Option premiums and markups on Foreign Options should be determined by the OCM, the foreign dealers and/or, if applicable, under the rules of the foreign commodity exchanges involved. Margining of premiums should not be permitted at levels which could adversely affect domestic futures markets.

(8) Advertising and promotional literature should not be submitted to the Commission prior to use, unless such submission is requested by the Commission. Any material so submitted may be used unless the OCM is advised within 30 days that the Commission has disapproved the material. All advertising and promotional material used must conform to specified standards.

(9) OCMs must employ "know-your-customer" rules in entering into option transactions. This includes an affirmative duty to consider whether the transaction is suitable for a particular customer.

(10) OCMs should be subject to reparation procedures either as provided in Section 14 of the Act or through the adoption of separate reparation provisions.

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(11) The Commission should consider whether a force majeure clause should be approved by the Commission prior to (a) its inclusion in an option contract or (b) its exercise by the OCM or (c) both its inclusion and its exercise.

(12) Aside from force majeure clauses, no option contract should be permitted to be sold which would permit an OCM unilaterally to terminate or to alter its material obligations to customers.

PART I - REPORT

RESPONSIBILITIES OF THE ADVISORY COMMITTEE

The Advisory Committee has been charged with the responsibility, inter alia, to submit a report and recommendations to the Commission on the following subject:

> Appropriate standards to be utilized by the Commission in regulating forms of transactions that are subject to the Commodity Exchange Act, as amended by the CFTC Act, including consideration of such matters as:
>
> (ii) Appropriate restrictions or prohibitions for options relating to commodity transactions . . . 1/

At the organizational meeting of the Advisory Committee held on November 19, 1975, its Chairman, Commissioner John V. Rainbolt, II, announced the formation of three subcommittees, including a Subcommittee on Commodity Options (the "Subcommittee"). 2/ The Chairman defined the role of the Subcommittee as follows:

> The Options Subcommittee . . . will consider the very significant question of whether commodity options should be allowed to be traded in the United States, and if so, under what regulatory

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1/ The description appeared in the official notice of the establishment of the Advisory Committee. 40 Fed. Reg. 32866 (August 5, 1975).

2/ The Advisory Committee members selected by the Chairman to serve on the Subcommittee were: Paul H. Franklin, Dr. Roger W. Gray, Sam Israel, Jr., Dr. Henry Jarecki, Edmund R. Schroeder, Dr. Myron Scholes, and Stephen F. Selig.

On March 19, 1976, Dr. Scholes was dropped from membership on the Advisory Committee and replaced by John M. Mount as a member of the Subcommittee.

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Thereafter, the Subcommittee established as its goals:

(1) To decide, and advise the Commission, on what forms of commodity option trading, if any, should be permitted in the United States; and

(2) To formulate considerations to be used by the Commission in establishing a regulatory framework for permissible option trading.

These goals were subsequently endorsed by the Advisory Committee.

In formulating its recommendations, the Advisory Committee considered the historical background of option trading 4/, the testimony of witnesses at hearings 5/, reports prepared by the Advisory Committee staff, Commission regulations and proposed regulations applicable to option transactions (and comments thereon) and various letters and statements submitted by members of the Advisory Committee and the public on different aspects of the Advisory Com-

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3/ Statement of John V. Rainbolt, II, before the Advisory Committee on Definition and Regulation of Market Instruments, Washington, D.C., November 19, 1975, pp. 2-3.

4/ Attached as Exhibit I to this report, pp. 84-104, is a brief history of option trading in the United States prepared by the Advisory Committee staff.

5/ Advisory Committee hearings on option trading and other matters were held on January 14, and 21, 1976. Those hearings and all written submissions received with respect thereto, as well as the minutes of the Subcommittee's and the Advisory Committee's deliberations on option trading, are on file with the Commission and available for inspection by members of the public.

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mittee's deliberations. 6/ It was also provided with the Subcommittee's views on the anticipated economic effects of option trading. 7/ In connection with all of the foregoing, the Advisory Committee considered the Commission's authority to regulate option trading, a summary of which immediately follows.

6/ Attached as Exhibit VI, pp. 172-175, is a bibliography of all informational materials (other than the Advisory Committee's hearings and certain exhibits to this report) utilized by the Advisory Committee and/or the Subcommittee in their deliberations on option trading. These materials are on file with the Commission and available for inspection by members of the public.

7/ Attached as Exhibit II, pp. 105-146, is a general statement of the "Subcommittee's Views on the Economic Effects of Option Trading."

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COMMISSION AUTHORITY TO REGULATE OPTION TRANSACTIONS

The principal authority of the Commission to regulate option trading is contained in Section 4c of the Act. Section 4c(a) expressly forbids option transactions relating to those commodities which were regulated under the Act prior to the enactment of the CFTC Act[8/], thereby continuing the Act's prohibition with respect to those commodities.

With respect to commodities that are newly regulated by virtue of the Act's expanded definition of the term "commodity," 9/ the Act provides, in Section 4c(b), that:

> No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this Act, but not specifically set forth in section 2(a) of this Act, prior to the enactment

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8/ Prior to the effective date of the CFTC Act, the Act provided for the regulation of " . . . wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice."

9/ The expanded definition of commodity includes in addition to the specific commodities set forth in Section 2(a)(1) of the Act (see ftn. 8 above), "all other goods and articles [except onions] . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in . . . ." (Section 2(a)(1)).

> of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets.

Thus, with respect to these newly-regulated commodities, the Commission is empowered, under Section 4c(b), to determine if and under what circumstances option trading will be permitted. Pursuant to this broad authority, the Commission could (a) prohibit all option trading, (b) permit all option trading "under such terms and conditions as the Commission shall prescribe," or (c) permit some forms of option trading (subject to Commission rules and regulations) and prohibit others. 10/

10/ A memorandum discussing the Commission's authority to regulate commodity option trading prepared by the Advisory Committee staff is attached as Exhibit III, pp. 147-151.

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ADVISORY COMMITTEE RECOMMENDATIONS

On May 10-11, 1976, the Subcommittee presented its recommendations to the Advisory Committee for its consideration. The Advisory Committee adopted the Subcommittee's recommendations with certain exceptions and modifications. Those recommendations, as so modified, are set forth below. Mr. Rodney E. Leonard filed dissenting remarks to the adoption of the Advisory Committee's recommendations. These remarks appear at pp. 56-80 of this report.

1. Option trading in general should not be prohibited.

The ultimate questions to be decided by the Commission with respect to commodity options are: (1) whether option trading should be permitted, and (2) if so, on what terms and conditions. In answering the first question, the Advisory Committee is strongly of the view that it is not necessary to demonstrate an improvement or betterment of the public interest in order to permit option trading, any more than it is necessary to establish an affirmative justification for engaging in any other form of economic activity. Rather, it should simply be required that the public interest will not be so adversely affected by such trading that there is sufficient reason to prohibit it. In that connection, the Advisory Committee concluded that options have been and are being legitimately used by commercial and other interests in ways that are not contrary to the public interest and that a sufficient case has not been made for banning option trading in general. (A summary of the Subcommittee's views on the economic effects of option trading is attached as Exhibit II, pp. 105-146.)

The Advisory Committee does not believe that any particular form of option trading should be prohibited, absent a finding that such transactions (A) are illegal or inherently fraudulent or manipulative, or (B) are contrary to the public interest in that they have a material adverse economic effect on futures markets or otherwise, or (C) do not provide three of the basic customer protections afforded to users of contract markets, or the equivalents thereof, designed to assure the financial integrity of, and to prevent manipulation or fraud in, option transactions, i.e., (1) segregation of funds 11/; (2) a mechanism guaranteeing performance of the transaction; and (3) adequate supervision and control of trading practices and activities. The Advisory Committee is unable to make such a finding with

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11/ Section 4d(2) of the Act provides generally that all money and other property deposited by customers to margin futures contracts or accruing to customers as a result of such contracts shall be segregated from an FCM's assets and treated as belonging to the customers.

As applied to option transactions, the Advisory Committee recommendations contemplate that a similar segregation procedure would apply to (a) option premiums, until such time as an option is liquidated by exercise, lapse or an offsetting transaction, and (b) any open trade equity of customers. See Recommendations 3(c)(2) and 4(c)(4), p.30, and pp. 47-48, respectively.

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respect to all forms of option trading. 12/ However, the Advisory Committee does believe that for one or more of the above reasons, certain forms of option trading should be prohibited. 13/

Another customer protection afforded users of contract markets is a competitive pricing mechanism. The Advisory Committee believes that such a mechanism is desirable with respect to option trading and should be required by the Commission where feasible. The Advisory Committee notes, however, that all forms of option trading may not be susceptible to a competitive pricing mechanism, such as in the case of a single dealer offering options in a particular commodity. Therefore, the Advisory Committee believes that the absence of such a mechanism where it is not feasible should not be a bar to any particular form of option trading.

In its consideration of option trading, the Advisory Committee identified three broad areas in which trading might occur in the United States: (A) trading in options on contract markets designated by the Commission, (B) trading in "Domestic Dealer Options," i.e., domestic options not originating on a designated contract market, and (C) trading in "Foreign Options," whether or not originating on an organized foreign commodity exchange. The following recommendations relate

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12/ In reaching this conclusion, the Advisory Committee is not passing judgment on the practices of any option vendor or the individual components of any option contract.

13/ See Recommendations 3(a) and 4(a), pp. 23-25, and p. 37, respectively.

to these three areas and the various forms of options which might be traded within those areas.

2. Domestic trading in options should not be prohibited:.

   (a) on contract markets, or
   (b) off contract markets in the case of Domestic Dealer Options on physical commodities and Foreign Options;

   provided that there has been a showing satisfactory to the Commission that, in either (a) or (b), protections substantially equivalent to those afforded futures customers on contract markets (as hereinafter described) are available. In addition, "trade option transactions" should not be prohibited and should be allowed pursuant to the conditions set forth in Recommendation 4(b) below, pp. 38-39.

The Advisory Committee believes that three basic customer protections, or their equivalents, are necessary to assure the financial integrity of, and to prevent manipulation or fraud in, option transactions: (A) segregation of funds; (B) a mechanism guaranteeing performance of the option (by the grantor and/or to the customer); and (C) adequate supervision and control of trading practices and activities.

The Advisory Committee believes that once these protections or their equivalents are extended to option transactions on contract markets, no reason exists for prohibiting such transactions. Accordingly, the Advisory Committee's recommendation in 2(a) above is that contract market option trading be allowed, subject to the "Specific Proposals with Respect to Option Trading on Contract Markets" set forth

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In considering off contract market option trading, the Advisory Committee addressed the fact that, in the deliberations leading up to adoption of the CFTC Act, the Senate Committee on Agriculture and Forestry made the following statement:

> "The Committee intends that options not be traded except on organized exchanges and in conformity with the rules and regulations of the Commission." 14/

The statement raised a question as to whether it was the intent of Congress that option trading be confined solely to organized exchanges. The Advisory Committee concluded that this was not the Congressional intent, but rather the objective was to assure that option trading would be limited to markets which are structured and regulated so as to afford the types of basic customer protections which exist on contract markets. The Advisory Committee based this conclusion on the fact that the Act itself does not specify the markets to which option trading must be confined, but instead grants the Commission extremely broad discretion in regulating all aspects of option trading. Accordingly, the Advisory Committee interprets the sentence quoted above as an expression of the Senate Committee's concern with which the Commission is authorized to deal by such means as it finds to be the most efficacious.

The Advisory Committee considered separately both

14/ S. Rep. No. 93-1131, 93d Cong., 2d Sess. at 26 (1974).

Domestic Dealer Options and Foreign Options, particularly foreign commodity exchange options vended in the United States and written by or through members of the International Commodities Clearing House in London and the London Metals Exchange. It is the Advisory Committee's recommendation that dealers in Domestic Dealer Options, foreign commodity exchange options, or for that matter any other Foreign Option, present to the Commission a system by which any such options could be traded in the United States under substantially equivalent protections as those afforded futures customers on designated contract markets. Thus, as expressed in part (b) of this recommendation, neither Foreign Options nor Domestic Dealer Options should be excluded from domestic trade, but should be traded only in conformity with the protective criteria enunciated above. For example, a self-regulatory body of domestic dealers (either in the form of a Title III assocation described in Section 17 of the Act, or in some other form) or a foreign commodity exchange that provides customer protections substantially equivalent to (A) segregation of funds, (B) guarantee of performance and (C) supervision and control of trading practices and activities, could be acceptable vehicles through which these options could be traded in the United States.

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If any such system is submitted to, and approved by, the Commission, the Advisory Committee urges that the "Specific Recommendations with Respect to Option Trading Off Contract Markets, i.e., Domestic Dealer Options and Foreign Options", contained on pp. 37-55 of this report, should apply. Some of those specific recommendations may, indeed, overlap or amplify the essential protections specified above. Nonetheless, once the Commission has determined that the essential protections are present, it may use the specific recommendations as standards for the regulations under which such trading will be allowed.

The Advisory Committee is aware that Section 15 of the Act requires that the Commission take into account the public interest to be protected by the antitrust laws and to endeavor to take the least anti-competitive means of achieving the policies and objectives of the Act in adopting any regulations. One of the more important policies and objectives of the Act is that commodity transactions regulated by the Commission be conducted in a manner that assures their performance and prevents fraud or manipulation. The Advisory Committee, based upon all of the evidence presented, concluded that the prevention of fraud and manipulation, as well as the promotion of financial integrity in option transactions, are objectives of the Act that outweigh any anti-competitive effects that might result from adopting the basic protections contained herein, and thus believes that its recommendations conform with Section 15 of the Act.

3. Specific Proposals with Respect to Option Trading on Contract Markets

The Advisory Committee believes that, for regulatory purposes, no distinction should be made between options on actuals and options on futures contracts traded on contract markets. Irrespective of the purpose for which either option is purchased, the Advisory Committee believes that they will be marketed and cleared in essentially the same manner and each would ultimately permit delivery to be taken of an underlying commodity. However, the consensus of the Advisory Committee is that it appears doubtful that option trading on actuals on designated contract markets will be initiated in the near future. As a consequence, the Advisory Committee does not believe that formal requirements regulating such trading are presently warranted. In the event the Commission receives an exchange proposal for such trading, the Advisory Committee believes that the Commission should analyze the proposal carefully and base its decision to permit or deny trading on the terms of the proposal and any other factors which the Commission considers pertinent. Should the Commission permit such trading, the Advisory Committee urges the Commission to monitor its effects closely.

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Accordingly, the following recommendations only concern contract market options involving domestic futures contracts. With respect to these options, the Advisory Committee distinguished between "transferable" and "non-transferable" options on the one hand, and "assignable" options on the other. For purposes of these recommendations, "transferable" means capable of being liquidated by an equal and off-setting transaction through a contract market; "non-transferable" means not capable of being liquidated by such an off-setting transaction. "Assignable" means capable of being conveyed to a third party off the contract market, irrespective of whether the option is "transferable" or "non-transferable". To illustrate these distinctions, futures contracts, as they are now traded on contract markets, are "transferable" in that a futures position can be liquidated through offset. 15/ However, they are "assignable" only under limited circumstances prescribed by rules of the Commission and the contract markets, *e.g.*, transfers of futures against actuals. Since futures contracts are not freely "assignable" there is no secondary market in futures.

3(a) Trading in assignable options on domestic futures contracts should be prohibited.

One rationale for prohibiting assignable options on

15/ *Cf.*, options cleared by the International Commodities Clearing House in London, which are "non-transferable" and which may only be liquidated by exercise or lapse.

futures contracts is that the purchase and sale of futures contracts are executed only on designated contract markets and the Advisory Committee is informed that the Commission staff considers futures trading off contract markets to be in violation of Sections 4c(a)(C) and 4h of the Act. On this basis, there was some concern expressed by the Advisory Committee as to whether an option, which in effect creates an interest in a futures contract, may be legally purchased or sold except on a contract market.

An additional reason for this recommendation is that an assignable contract market option could result in the creation of a secondary market in contract market options. Such a market could adversely affect the liquidity of the exchanges' options markets, and in addition, would interfere with their ability to discharge their responsibility to assure the customer protections set forth in Recommendation 2, *i.e.*, segregation, a performance guarantee and supervision. Moreover, it would be most difficult to regulate a secondary market composed largely of participants whose identity and number would be in constant flux.

The Advisory Committee is aware that Section 15 of the Act requires the Commission to take into account the public interest to be protected by the antitrust laws and to endeavor to take the least anti-competitive means of achieving the policies and objectives of the Act in adopting any regulations. The Advisory Committee believes

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that two such policies and objectives are that commodity instruments involving futures contracts should be traded solely on contract mar[illegible] and that the contract markets and their members should be able to supervise the orderly trading of any exchange-generated instruments. The Advisory Committee does not believe that trading in assignable options on futures off contract markets would be consistent with those policies and objectives.

3(b) Trading in non-assignable options on domestic futures contracts should not be prohibited regardless of whether the options are transferable or non-transferable.

As set forth in Recommendation 2, the Advisory Committee has concluded that, in general, contract market option trading should not be prohibited. This conclusion applies regardless of whether the options traded are transferable or non-transferable.

Both forms of trading have advantages and disadvantages from the point of view of a seller, a buyer and the exchanges on which trading may occur.

In the case of non-transferable options (which are the type presently traded on several London exchanges and cleared by the International Commodities Clearing House), the position of a seller is somewhat inflexible. He cannot liquidate his position through an offsetting purchase; he can only protect his position through the ownership of the physical commodity, a futures contract, or another option, any of which involve greater cost and/or risk than liquidation by offset. This may result in higher option premiums for non-transferable options. In addition, the inability to close out a seller's position makes it more difficult for the carrying broker or, in the case of a clearing member, for the clearing house, to protect itself against a default by the seller. This fact will probably cause brokerage firms and clearing houses to impose higher financial standards on sellers of non-transferable options, thereby reducing the number of qualified persons available to sell options.

The buyer of a non-transferable option may realize upon the option either by trading against it in the futures market or by exercise. He cannot simply sell out a profitable option position. As a result, the buyer is deprived of one method of realizing on the option.

The potential effects of trading in non-transferable options on futures markets are extremely difficult to predict. It is possible that such trading could add some measure of liquidity to such markets. Since a buyer of a non-transferable option cannot resell the option, he can only realize any profit by trading a futures contract against the option or by exercising the option, thereby receiving a futures contract which he may liquidate by an offsetting futures transaction. In addition, as indicated above, the seller of such an option may be

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With respect to futures market volume, since non-transferable options will probably be less attractive to buyers and sellers than transferable options, they will be less likely to draw traders away from the futures markets.

Transferable options, on the other hand, afford both the seller and the buyer greater flexibility than non-transferable options, since either party can readily close out his position by effecting an offsetting option transaction. [16] This is especially important to a seller who, by offset, can avoid the costs and/or risks of covering in physicals, futures or options, and who therefore might offer his option at a lower premium. Furthermore, the carrying broker or the clearing house can readily close out a defaulting seller. This should permit less stringent financial requirements to be set for option sellers, thereby potentially increasing their number. It is possible that transferable options could reduce futures market volume, since they may prove more attractive for some traders than futures contracts and since traders could realize a profit merely through buying and selling such options without going into the futures market. Whether, and to what extent, this could occur and might adversely affect futures markets cannot be predicted. It is also possible that trading in transferable options could attract traders who do not currently trade on the futures market.

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[16] The Advisory Committee understands that two contract markets, Commodity Exchange, Inc. and the Pacific Commodities Exchange, Inc., have applied for Commission approval of option trading, both of which contemplate trading in transferable options which would not be assignable.

The Advisory Committee believes that, in view of their relative merits, if trading were instituted in both transferable and non-transferable options on the same commodity, in all probability most or all of the trading would gravitate to the transferable options.

In weighing the potential benefits against the possible hazards of trading both transferable and non-transferable options, the Advisory Committee concluded that neither form of trading should be prohibited as such. However, before approving any plan for option trading on a contract market, the Commission should first examine, to the extent possible, what the effect would be upon futures trading if option trading were instituted. Moreover, since there has been no experience with transferable commodity options and only limited experience with non-transferable commodity options, the Advisory Committee urges the Commission to monitor carefully such option trading as may be instituted.

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3(c) In general, trading in options involving futures contracts on designated contract markets should be regulated in a similar fashion to futures contracts, subject to any particular differences stated in recommendations (1) - (8) below. 17/

(1) Registration. Persons who are engaged in soliciting or accepting orders for the purchase or sale of any option involving futures contracts on designated contract markets and accepting margin or premiums (or extending credit in lieu thereof) in connection therewith should be required to register with the Commission as Futures Commission Merchants (FCMs). All "Associated Persons" of such persons and of their agents should register with the Commission in accordance with Section 4k of the Act.

The Advisory Committee believes that persons engaged in the activity described above are engaged in the offer and sale of interests in futures contracts. Should it be determined, by the Commission or otherwise, that such persons are FCMs, they should be registered accordingly. Persons already registered as FCMs need not re-register as a result of this activity. In this connection, Commission Regulation 1.19, which prohibits FCMs from assuming financial responsibility for option transactions, should be repealed. The Advisory Committee suggests that the Commission modify its registration forms for FCMs so that applicants must show whether they are, or plan to become, engaged in this, or any other, form of option trading. The Advisory Committee also suggests that persons registered as FCMs notify the Commission when they first engage, or plan to engage, in any form of option trading.

17/ Certain of recommendations (1) through (8) below relate to FCMs. The Advisory Committee wishes to point out that FCMs whose option activities are limited to option trading on contract markets need only comply with those recommendations. Should the FCM engage in other forms of option trading, additional requirements will apply to those activities. For example, the FCM will have to register in an additional category. See Recommendations 4(c)(1)-(12) below.

Should it be determined, by the Commission or otherwise, that persons engaged in this form of option trading are not FCMs, the Advisory Committee urges the Commission to develop and implement a separate category of registration for them and subject them to the Act's reparation procedures. 18/

(2) Segregation of Funds. Consistent with Recommendation (1) above, all monies, excluding commissions, and other property received from customers by FCMs in this type of option transaction (as well as any open customer trade equity) should be treated and dealt with in the manner prescribed in Section 4d(2) of the Act for customers' funds in futures transactions.

The Advisory Committee believes that the segregation requirements of the Act are the cornerstone of the protections afforded to customers dealing in futures markets. Therefore, it believes that this protection should be applied with no less force on behalf of those who use their funds to acquire or sell an option to purchase or sell interests in futures contracts. Should it be determined that segregation cannot effectively insulate the funds paid by customers from claims of other creditors under existing law, legislation to accomplish that result should be sought.

(3) Financial Requirements. The present financial requirements for FCMs imposed by Commission Regulation 1.17 should be amended to reflect the FCM's activities in option trading, both for customers and

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18/ For convenience, the category of "Option Commission Merchant" ("OCM") might be used. See Recommendation 4(c)(1), pp. 43-44. As to reparations, see Recommendation 4(c)(10), p. 54.

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for its own account, including appropriate "haircuts" 19/ and/or safety factors.

Any applicable financial requirements, whether imposed by the Commission or by contract markets and approved by the Commission, must take into account FCMs' option transactions. Subject to any financial requirements of an individual contract market, the Advisory Committee does not believe that any distinction should be drawn between member and non-member FCMs.

The Advisory Committee believes that the contract markets' clearing mechanisms and the application of the Act's segregation requirements, if legally effective, offer sufficient customer protection so as to make separate financial requirements unnecessary. However, the Advisory Committee wishes to stress that separate financial requirements should be imposed if the FCM also engages in option activities off designated contract markets (see recommendations commencing on page 37 below).

(4) Financial Reporting. The Commission should determine what additional financial reporting requirements should be imposed on FCMs to reflect the FCM's activities in option trading, both for customers and for its own account.

The Advisory Committee believes that this recommendation is self-explanatory.

19/ As used herein, the term "haircut" means a reduction in the market value of an asset used in computing capital in order to meet financial requirements.

(5) Option Premiums. The amount of option premiums on contract markets should be competitively determined by open outcry. Subject to certain limitations, contract markets and FCMs should be permitted to determine the extent, if any, to which such premiums may be margined by customers.

The Advisory Committee believes that the first sentence of this recommendation is self-explanatory. The Advisory Committee does not believe that the margining of option premiums on contract markets should be prohibited. The Advisory Committee has heard arguments both for and against this concept 20/ and, on balance, has concluded that the margining of option premiums is feasible in programs where (a) the original margin on the premium is at least equal to the original margin on the underlying futures contract; and (b) options are "marked-to-market" each day by the contract market or its clearing organization and calls for additional margin are made promptly to customers (up to the full premium cost) when adverse market movements occur. The Advisory Committee also believes that the self-interest of those contract markets which propose to have such option trading will lead them to establish margins at levels which will not result in an adverse impact on their own futures markets. The Advisory Committee points out that this is a complex subject and cautions the Commission to monitor carefully the effects of this type of option trading, particularly

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20/ Attached as Exhibit IV, pp. 152-170, is a summary of the arguments for and against margining of option premiums on contract markets.

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(6) Disclosure. FCMs should be required to make the same disclosure to customers with respect to these option transactions as they are required to make to their customers concerning futures transactions.

The Advisory Committee believes that the foregoing recommendation is self-explanatory.

(7) Advertising and promotional literature. The Commission should generally monitor advertising and promotional materials but should not assume the responsibility of approving such materials.

In the opinion of the Advisory Committee, the amount of advertising and promotional literature concerning option trading which will be generated by FCMs, commodity trading advisors and others is uncertain, but may prove substantial. The Advisory Committee questions whether the Commission will have the resources to review advertising material adequately prior to use and believes that it could more efficiently monitor materials through periodic spot checks. Even if the Commission adopted a "non-disapproval" review process generally, the public probably would infer that the Commission had given its tacit approval to the material. Furthermore, the Commission could be subject to a great deal of criticism should a fraudulent piece of advertising be overlooked in the review process. Such criticism could also occur even if the material were merely filed with the Commission prior to use. There may be situations, however, where the Commission will have a need to review advertising and promotional material in advance of its use. In those instances, the Commission should have the right to request that such material be submitted to the Commission in advance. Where such advertising and promotional material has been so submitted, the Commission should be given a reasonable time to review its contents (no longer than 30 days) and to state whether it disapproves of its use. If such disapproval is expressed, the FCM or contract market should be precluded from using the material.

The Commission should make clear that the party using advertising and promotional material will do so at its own risk and subject to applicable provisions of the Act and the regulations thereunder, including the Commission's antifraud rule governing option transactions. However, should the Commission have requested and reviewed such material without disapproval, any enforcement action taken by the Commission should not be based solely on the text of such material.

In addition, the Commission should require that all advertising and promotional material used: (1) must contain a statement that it has not been approved or disapproved by the Commission, (2) may not be false or misleading, (3) must give a fair presentation of the risks and rewards, (4) must be retained for such period as the Commission shall prescribe, and (5) must be available for inspection by representatives of the Commission upon its request.

The Advisory Committee notes that the foregoing should not apply to contract market advertising and promotional ✓ material regarding options. Rather, such advertising and promotional materials should be subject to the same standards and requirements as the Commission may adopt regarding ✓ contract market advertising and promotional material regarding futures contracts.

The Advisory Committee is particularly concerned with the potential problems associated with oral promotional activity. For example, oral misstatements and misrepresentations are often the greatest source of fraud perpetrated on the public. The Advisory Committee recognizes, however, that it would be impossible for the Commission to screen oral presentations prior to their use. Nevertheless, the Advisory Committee urges the Commission to employ substantial vigilance to detect promotional abuses and to enforce vigorously its antifraud rule with respect to option transactions where it believes such abuses have occurred.

(8) Know-your-customer rules. Any know-your-customer rules imposed by the Commission on FCMs in connection with their futures transactions should be extended to their option transactions.

The Advisory Committee sees no reason to distinguish between an FCM's futures and option transactions for this purpose.

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3(d) In evaluating contract market proposals for trading options on futures contracts, the Commission should pay particular attention to the proximity of the expiration date of the option to the delivery period on the underlying futures contract. In addition, the Commission should require exchanges to publish data on open option positions.

The Advisory Committee believes that the Commission should consider requiring that the expiration date of any option contract precede the delivery period on the underlying futures contract by a sufficient period to minimize the potential for the exercise of options to contribute to congested conditions in the futures market.

The Advisory Committee also believes that publication of information with respect to open option positions would be helpful to indicate the size of the current market to market participants.

3(e) Different contract market trading. In general, option trading on futures contracts should be limited to the contract market on which the underlying futures contract is traded.

The Advisory Committee is doubtful that the Commission will receive an application to trade options on futures contracts by an exchange on which the underlying futures contract is not traded. However, if such an application is received, it should not be approved unless it can be demonstrated to the satisfaction of the Commission that the customer protections set forth in Recommendation 2 can be provided and that the proposal will not have a material adverse effect on the contract market on which the underlying futures contract is traded.

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In no case should the Commission authorize a plan for option trading on an exchange without the consent of the contract market on which the underlying futures contract is traded.

4. Specific Recommendations with Respect to Option Trading Off Contract Markets, i.e., Domestic Dealer Options and Foreign Options

4(a) Trading off contract markets in options involving domestic futures contracts should be prohibited.

As indicated in Recommendation 3(a), pp. 23-25, the Advisory Committee is informed that the Commission staff considers trading in domestic futures off contract markets to be in violation of the Act. On this basis, the Advisory Committee again expressed concern as to whether an option, which in effect creates an interest in a futures contract, may be legally purchased or sold except on a contract market.

In addition, the Advisory Committee is concerned that this form of trading could have an adverse effect on the volume and liquidity of futures markets, in that option premiums, and/or margins thereon, could be set at levels substantially lower than the margins on the underlying futures contracts, a process over which the contract markets would have no control. As a result, customer capital which otherwise might be allocated to futures markets could be drawn to this form of option trading.

4(b) "Trade Options" should not be prohibited and should be exempt from Commission regulation, except for the Commission's general antifraud rule governing option transactions.

For purposes of the above recommendation, the Advisory Committee considers a trade option transaction to be:

> any commodity option transaction involving a physical commodity in which the grantor and the grantee are either (a) engaged in the business of or financing of growing, mining, producing, merchandising, dealing in, processing, refining, smelting, manufacturing, milling or otherwise putting to industrial or commercial use 21/ the commodity which is the subject of the option transaction, any related commodity, any product or by-product of such commodity or related commodity, or any item containing any such commodity, related commodity, product, by-product or raw material; or (b) registered as an FCM; provided, however, that such option transaction is related to a principal business activity of the grantor and of the grantee. Each party to a commodity option transaction shall be entitled to rely on any written representation by the other party that such other party falls within category (a) or category (b), provided that the party receiving the representation reasonably believes it to be true. With reference to any commodity, the term "related commodity" shall mean any item, whether or not a "commodity" within the definition set forth in the Commodity Exchange Act, the price of which tends to move in the same direction as such commodity.

The Advisory Committee believes that the burdens associated with registration and compliance with its other proposals for Domestic Dealer Options and Foreign Options (see Recommendation 4(c) below), should not apply to strictly off-exchange, private, commercial dealings

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21/ As used herein, "industrial or commercial use" is not intended to include persons who casually use a commodity as an incident to their business.

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between and among commercial and industrial firms or dealers or FCMs. Such persons are sophisticated in business and financial matters generally, and in particular, are cognizant of the relevant information necessary to evaluate commodities transactions.

The Advisory Committee points out that the Commission's antifraud rule would apply to trade option transactions. In addition, the Advisory Committee notes that its definition of a trade option would not apply to a transaction with the public. Thus, should the trade option be re-sold or otherwise conveyed to a "non-trade" individual or entity, the exemption would not apply to this transaction and compliance with the Advisory Committee's proposals for Domestic Dealer Options and Foreign Options would be necessary upon such resale or conveyance. The Advisory Committee also points out that the trade option exemption is not intended to relieve an FCM of its obligations to include the financial commitments it incurs in the trade option transaction in computing its working capital under section 1.17 of the Commission's regulations.

4(c) If permitted by the Commission, trading in the United States of Domestic Dealer Options or Foreign Options should be regulated in accordance with recommendations (1) through (12) below.

The Advisory Committee's primary concern in preparing recommendations for United States trading in Domestic

Dealer Options and Foreign Options is that the Commission should regulate such trading to protect customers to the greatest extent possible, particularly in the areas of safeguarding their funds and assuring the performance of obligations to them under the option contract.

Accordingly, as stated in Recommendation 2, the Advisory Committee believes that trading in the United States of Domestic Dealer Options or in Foreign Options should be permitted only if three basic customer protections will be provided: segregation of funds, a guarantee of performance and adequate supervision and control of trading activities and practices.

Recent experience in the United States concerning the sale of Domestic Dealer Options appears to warrant such requirements. For example, the Advisory Committee understands that one company's insolvency resulted in a loss of 71 million dollars of customers' money. Due to the lack of regulation by the imposition of financial, segregation and other requirements, the only customer safeguard in this and other instances was the good faith and credit of the company involved. Many customers who desired their proceeds in such transactions were paid with other customers' funds. Ultimately these structures collapsed. 22/

The Advisory Committee has similar concerns with

22/ H.R. Rep. No. 93-975, 93d Cong., 2d Sess., 37 (1974).

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respect to the trading of Foreign Options in the United States. The Advisory Committee recognizes that any proposals to prohibit or to regulate Foreign Option transactions in the United States must be viewed in the context of international relations, both political and economic. In its deliberations, the Advisory Committee has given due consideration to these factors, while at the same time endeavoring to discharge its primary responsibility to formulate recommendations consistent with, and to effectuate its perception of, the policies and objectives of the Act.

The Advisory Committee's deliberations in the area of Foreign Options have been limited to the sale in the United States of options written or purported to have been written by or through members of the International Commodities Clearing House ("ICCH") in London and the London Metals Exchange ("LME"). Particular concern has been expressed with respect to the financial arrangements relating to both of these institutions, the option clearing mechanism utilized, if any, the transactional guarantee provided by each, and the manner in which these options are marketed in the United States.

At the present time, neither United States nor London vendors of ICCH or LME member options are required to segregate funds received from United States customers. Moreover, neither the ICCH nor the LME currently guarantees to United States customers the performance of obligations on any ICCH or LME option. The Advisory Committee has been informed that these and other circumstances, such as the absence of financial requirements for option dealers in the United States and the lack of regulation of the United States market for Foreign Options, make it very difficult for United States customers to obtain redress in the United States from dealers of "London" options in the event of a default on the option transaction. On this basis, the Advisory Committee has determined that, to the extent possible, these deficiencies should be remedied by the Commission. Of course, it is difficult to foresee the various methods by which other foreign persons or entities might write options and endeavor to market them in the United States. Accordingly, safeguards in addition to those proposed by the Advisory Committee may prove necessary to assure customer protections in transactions of which the Advisory Committee is presently unaware.

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The following specific recommendations relate to United States trading in Domestic Dealer Options and in Foreign Options. They apply both to an option which may be reconveyed by the holder to the dealer and to an option which may be assigned or otherwise conveyed by the holder to a third party. The Advisory Committee sees no reason

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to distinguish between these types of options for regulatory purposes. To the extent that such options are assignable, they afford the customer additional liquidity and do not place him at the price mercy of his dealer, even should such dealer be willing to repurchase the option. Of course, should a person assign such options on other than a casual basis, he would be creating a secondary market and would be a "dealer" (as defined below) in such market. The following recommendations apply to both primary and secondary option markets.

(1) Registration. Dealers 23/ of Domestic Dealer Options and Foreign Options should be registered with the Commission as option commission merchants (OCMs). 24/ If such persons are already registered as FCMs, no additional registration should be required. These FCMs should be required, however, to comply with all other substantive regulations applicable to OCMs. Registration of OCMs should include the Commission's fitness checks and statutory and interpretive standards for denial of registration, and any additional standards the Commission deems appropriate with respect to the applicant or its affiliated persons. All "Associated Persons" of the OCM and its agents should register as well as the agents themselves.

23/ For purposes of this recommendation, "dealers" means persons engaged in the business in the United States of writing or guaranteeing Domestic Dealer Options or Foreign Options or offering or selling such options as principals or agents.

24/ The category or categories in which dealers should register should be determined by the Commission. The term OCM has been selected for convenience only.

As previously indicated in Recommendation 3(c)(1), pp. 29-30, the Commission should modify its registration forms for FCMs to reflect this form of option trading and FCMs should be required to notify the Commission when they first engage, or plan to engage, in this form of option trading.

The reasons for this recommendation are that all persons engaged in the business of option trading in the United States should register with the Commission as do other commodity trading professionals and should be subject to at least the same scrutiny in the registration process as those professionals. The Advisory Committee recognizes that the Commission may have difficulty enforcing its registration requirements with respect to foreign "dealers" offering or selling options, or whose options are offered or sold, in the United States who may claim that they are not "engaged in business in the United States." In these situations, the Commission should employ whatever means are available to it to protect the interests of United States customers, *e.g.*, by enjoining the offer or sale of such options by anyone located in the United States.

(2) Financial Requirements

(A) In addition to a working capital requirement, a minimum net worth requirement should be imposed on OCMs.

(B) The initial net worth and working capital requirements are minimum figures which should be increased as the dollar amount of open option positions increases. A specific requirement in this regard may prove unnecessary if appropriate "haircuts" and/or safety factors can accomplish the same result.

(C) To the extent practicable, the Commission should use a uniform system of accounting for all registrants who are subject to financial requirements under the Act, including OCMs.

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The Advisory Committee believes that to impose these financial requirements on OCMs would be an important element of a program designed to prevent fraud, to assure the financial integrity of commodity option transactions, and to otherwise afford customer protection by:

(1) requiring OCMs to have sufficient capital to meet outstanding obligations to customers under their option contracts;

(2) keeping out "fly-by-night" OCMs; and

(3) providing a cushion against losses due to any number of factors, e.g., dishonesty, incompetence, insufficient or inadequate segregation, etc.

As previously noted, the Advisory Committee is aware that Section 15 of the Act requires that the Commission take into account the policy of the antitrust laws. In this connection, the Advisory Committee recognizes that minimum levels of net worth and working capital for OCMs could tend to reduce competition and preclude entry into the business by OCMs who are unable to meet those tests. However, the Advisory Committee believes that Section 15 does not require that the Commission guarantee freedom of entry into the business if doing so would ignore the basic policies of the Act to prevent fraud and to assure the financial integrity of commodity transactions regulated by the Commission.

The Advisory Committee discussed the possibility of recommending specific minimum figures for net worth and working capital requirements, but determined not to do so. Nevertheless, the Advisory Committee recommends that any minimum figures established for net worth and working capital should take into account the dollar amount of open option positions.

(3) Computation and maintenance of customer equity. OCMs should be required on a daily basis to "mark to market" customers' open option positions and to allocate physically for the account of customers having net equity positions an amount of cash, cash equivalents or, in the case of an OCM's short call position, the physical commodity which is the subject of the option transaction (if readily marketable and of readily determinable value), equal to the customers' net equity positions. To the extent the customers' net equity positions subsequently decrease, the OCM may make a corresponding reduction in their accounts. The market to which the OCM shall mark in accordance herewith shall be fair and representative [25] and shall be specified in the basic disclosure document and the summary statement contemplated by Recommendation 4(c)(6), pp. 50-52.

The Advisory Committee believes that this recommendation, combined with those regarding financial requirements and segregation (see Recommendations 4(c)(2) and 4(c)(4), respectively) will, to a great extent, prevent fraud in, and assure the performance of, option transactions. In view of these recommendations, the Advisory Committee believes that physical "coverage" of open option positions is unnecessary.

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[25] For purposes of this recommendation such factors as the grade and quality of the commodity should be considered by the Commission in determining whether a market is "fair and representative," particularly in the case of soft commodities.

(4) Segregation. OCMs should physically segregate (a) all monies, excluding commissions, and other property received from customers in these types of option transactions and (b) all cash, cash equivalents, or the physical commodity which is the subject of the particular option transaction allocated to customers' accounts in accordance with Recommendation 4(c)(3) above. Segregation should be with an independent financial institution, or some other type of depository located in the United States, the qualifications for which have been established by the Commission. Any interest accruing on such segregated assets may be for the account of the OCM. Extension to an OCM's customers of an approved guarantee, by an institution located in the United States, of the safety of funds held for their benefit could be used as an alternative to segregation. OCMs should be required to maintain daily segregation records and to submit to the Commission a monthly segregation statement.

The Advisory Committee believes that, until such time as an option has lapsed or has been exercised, the assets referred to above should be treated as those of the customer. It also believes that physical and legally efficacious segregation of those assets is essential to assure the financial integrity of option transactions and to prevent manipulation or fraud. Absent segregation, these assets could be used by the OCM in its general operations, e.g., to meet operating expenses, and thereby would be unavailable to meet its financial commitments to customers. In addition, absent segregation, these assets might be subject to the claims of general creditors of the OCM; with segregation this danger may be alleviated. Accordingly, the Advisory Committee believes that, to the extent possible, these assets should be treated substantially in the same manner as futures contract "margin" is treated under Section 4d(2) of the Act. The Advisory Committee has suggested, however, that a substantive equivalent to segregation could be acceptable, such as the extension of an approved institutional guarantee of the safety of customer funds.

The Advisory Committee understands that the legal efficacy of segregation imposed by regulation is uncertain. As stated above (see Recommendation 3(c)(2), p. 30), the Advisory Committee recommends that the Commission seek appropriate legislation to assure that full recognition be given under the bankruptcy laws to assets segregated for the benefit of customers pursuant to Commission requirements.

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(5) Financial Reporting. OCMs should be required to prepare and furnish such financial statements as the Commission shall from time to time prescribe. At the least, OCMs should be required to file annual audited and quarterly unaudited statements with the Commission. OCMs should also prepare monthly financial statements which should be retained by the OCM for such period as the Commission shall prescribe and should be available for inspection. All financial statements of OCMs must be prepared in accordance with generally accepted accounting principles, consistently applied. The Commission should perform periodic audits. In the event that the OCM falls below the requisite standards which are established, the Commission should be in a position to take appropriate corrective measures, including the seeking of an injunction against further sales, the appointment of a receiver, the securing of an order of liquidation of the OCM and/or its open positions, pursuing criminal sanctions or taking whatever other measures are necessary or advisable.

The rationale for this recommendation is much the same as that contained under the recommendation for financial requirements above. Moreover, the Advisory Committee believes that to enforce properly the financial requirements that are imposed, it is imperative that the Commission require that suitable records be maintained and that they be presented regularly to the Commission for review and be available for examination by Commission personnel on a spot-check basis. Finally, the Commission should have all available enforcement tools at its disposal so as to act quickly in case of a financial downturn materially affecting an OCM.

(6) Disclosure.

(A) To Customers. An OCM should be required to make fair, meaningful and understandable disclosure about the OCM and its associates to a prospective purchaser prior to his entry into an option transaction. Such disclosure should be made by delivery of a basic disclosure document containing enough information to provide the prospective purchaser the opportunity to evaluate the OCM and its financial condition. It should be conspicuously disclosed as to whether the OCM will assume financial responsibility for the option. In any event, a clear explanation should be made of the obligations to the customer of each person or entity having financial responsibility in the option transaction. Such document should also contain the names and addresses of all OCMs guaranteeing the option transaction 26/, indicating that financial and biographical information with respect to such persons is available for inspection at the Commission. In addition to the basic disclosure document, an OCM should furnish prospective customers with a summary statement of the major aspects of the option transaction. A list of items which should be included in the summary statement is attached as Exhibit V, p. 171, to this report.

(B) To the Commission. OCMs should be required to file daily or weekly information with the Commission concerning market trading activity. At the least, this information should include the extent of the OCM's open option positions, their striking prices and their maturity dates.

The reason for the Advisory Committee's determination

26/ The writer of a Foreign Option which is "cleared" in a manner similar to that obtaining on the ICCH would not be considered a guarantor for this purpose.

that a prospective purchaser of this form of option contract should receive a basic disclosure document and summary statement is to afford him with the opportunity to evaluate the rights he expects [illegible] acquire, the qualifications of the option dealer with whom he is dealing, and the identity of those persons having financial responsibility in the option transaction. However, the Advisory Committee wishes to stress that its conception of "fair disclosure" does not imply that a "prospectus-type" disclosure document is required. The Advisory Committee believes that prospectuses often are lengthy and confusing and contain more information than is necessary for a fair evaluation. Indeed, at times they contain so much information that meaningful evaluation by investors is impaired. Nonetheless, a disclosure-type document (somewhat less detailed than a Securities Act prospectus, but giving essential information about the OCM and the transaction) should be delivered to prospective purchasers. As a supplement to that disclosure document, a summary statement is also deemed desirable. In this regard, the Advisory Committee believes that the receipt by the customer of a summary statement of the major aspects of the option transaction should enable the customer to focus upon the most essential aspects of the transaction.

With respect to disclosure to the Commission, the Advisory Committee believes that disclosure of open option positions, including their striking prices and maturity dates, will assist the Commission in monitoring the financial condition of the OCM.

(7) Option premiums, margins and mark-ups.

(A) In the case of Domestic Dealer Options, OCMs should be permitted to determine option premiums and any mark-ups thereon. With respect to Foreign Options, option premiums and mark-ups should be determined by the OCM, the foreign dealers trading therein and/or, if applicable, under the rules of the foreign commodity exchanges involved.

(B) Subject to the limitations set forth below, the margining of premiums on Domestic Dealer Options and Foreign Options should not be prohibited.

A policy of the Act is that the Commission does not oversee the method of establishing prices for commodities or the setting of levels of margins for futures contracts. The Advisory Committee sees no reason for a contrary policy to be applied to the amount of the premium charged on option transactions off a contract market. However, as indicated in Exhibit V, p. 171, the amount of the writer's original premium and any mark-ups thereon, should be disclosed separately to customers in advance of an option transaction.

With respect to the margining of premiums of options traded off contract markets, the Advisory Committee cautions the Commission that the setting of margins should not be permitted at levels which could adversely affect domestic

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futures markets. Also, as indicated in Exhibit V, the Advisory Committee urges that any margining of premiums by OCMs be disclosed to prospective customers to assure that they will be fully apprised of the fact that they may be subject to margin calls up to the total cost of the premium.

(8) Advertising and Promotional Literature. Advertising and promotional literature should not be submitted to the Commission prior to use, unless such submission is requested by the Commission. Any material so submitted may be used unless the OCM is advised within 30 days that the Commission has disapproved the material. All advertising and promotional material used: (1) must contain a statement that it has not been approved or disapproved by the Commission, (2) may not be false or misleading, (3) must give a fair presentation of the risks and rewards, (4) must be retained for such period as the Commission shall prescribe, and (5) must be available for inspection by representatives of the Commission upon its request.

The reasons for this recommendation and the concerns expressed by the Advisory Committee are essentially the same as those stated for advertising and promotional material related to options on contract markets. See Recommendation 3(c)(7) above, pp. 33-35.

(9) Know-your-customer rules. OCMs must employ "know-your-customer" rules in entering into option transactions of this type. This requirement includes an affirmative duty to consider whether the option transaction is suitable for a particular customer.

The Advisory Committee believes that suitability rules should be affirmatively considered by the Commission as a requirement for OCMs' option transactions.

(10) Reparations. OCMs should be subject to the Act's reparation procedures. This may be accomplished by requiring those OCMs who are not FCMs to register as commodity trading advisors. Alternatively, should the Commission not require such registration, it is recommended that the Commission consider adopting separate reparation procedures for OCMs or seeking legislation specifically extending the Act's reparation procedures to OCMs.

Although the Advisory Committee does not unanimously believe that the concept of reparations in the Act is necessarily a desirable development, it believes that, as in the case of registration, OCMs should be treated in the same manner as other commodity professionals and, therefore, should be subject to the Act's reparation procedures.

(11) Force Majeure clauses. The Commission should consider whether (a) the language of a force majeure clause, i.e., a clause which, because of the occurrence of a specified event, would excuse an OCM from performing its obligations to a customer or would permit the OCM to alter those obligations in this type of option transaction, should be approved by the Commission prior to its inclusion in an option contract, or (b) the OCM's exercise of a force majeure clause should be approved by the Commission prior to exercise, or (c) whether both approval procedures set forth in (a) and (b) should be adopted by the Commission. 27/

The Advisory Committee believes that to permit an OCM to enter into contracts containing overly broad force majeure clauses could deprive the purchaser of the benefits of his

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27/ The Advisory Committee notes that in the case of options on contract markets, any clauses on force majeure and unilateral termination or modification (see Recommendation 4(c)(12), p. 55, presumably would be contained in contract market proposals for option trading submitted to the Commission.

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purchase or impair the financial integrity of the option transaction, and could therefore tend to encourage fraudulent activity. Of course, there may be force majeure clauses which should be permitted to be exercised. The Advisory Committee believes that the Commission should adopt some procedure to approve force majeure clauses in option contracts and would suggest consideration of both a pre-inclusion and pre-exercise review.

(12) Unilateral termination or modification. Aside from force majeure clauses, no option contract of this type should be permitted to be sold which would permit an OCM unilaterally to terminate or to alter its material obligations to customers as regards outstanding options.

The Advisory Committee believes that to permit an OCM to enter into contracts containing unilateral termination or modification clauses could deprive the purchaser of the benefits of his purchase and therefore encourage fraudulent activity. Such clauses should therefore be proscribed.

DISSENTING REMARKS OF RODNEY E. LEONARD

In the introductory statement of issues to be addressed by the Advisory Committee, the principal question in relation to options was to advise the Commission on "whether commodity options should be allowed to be traded in the United States" on other than previously regulated commodities, "and if so, under what regulatory terms and conditions."

The Committee has yet to answer the first component of that question. Instead it has proceeded to the secondary component by the strawman strategem. The Committee has asked and answered another question which Congress has already answered and did not pose in relation to option trading: "Should the Commission use its legislative authority to prevent individuals from offering to sell or buy commodity options?"

Congress said the Commission should consider the first question. The Committee's report says, in effect, that to consider the question is an attack upon the free enterprise system, and therefore constitutes an exercise against the laws of nature.

The Committee, having rushed to the defense of its strawman, never returned to the basic issue of why trading in commodity options should be allowed. In so doing they have acknowledged but ignored several warning signals. It was only briefly noted that Congress banned option trading in 1936, although the discussions made clear that a majority of the Committee feels that Congress had made a major error in judgment which should be rectified. An enclosure to a January 12, 1976, memorandum from the Committee Chairman (Attachment 1 to these remarks) suggests that commodity option trading could excessively enhance changes in commodity prices, but that problem was dismissed with the assumption that option trading would somehow prevent distortions in market prices--even though the 1930's experience, which led Congress to ban the practice, proves the opposite.

The report makes little note of the position of New York Attorney General Louis Lefkowitz who found no redeeming virtue in option trading and recommended that it be banned. The Attorney General is the chief law enforcement officer of the State, and has more experience than anyone else with the problems of preventing the use of option trading to defraud the public.

What the Committee has done is recommend the conditions under which dealers in commodity options must operate, whether on or off a regulated exchange. The Committee argues that these safeguards are adequate to protect those who will deal with commodity option traders. These conditions, however, are porous safeguards, since the Commission is going to have a difficult time with its limited staff in policing these transactions where they occur away from a regulated exchange. The standards are not safeguards as much as they are an attempt to assure competitive parity to futures merchants who fear that option trading will compete unfairly with the more conventional futures trading.

While it is well for the Committee to be concerned with the commodity industry, its failure to deal with the potential dangers to the economy and to consumers is troubling. During the discussions of the issues relating to cash price manipulation, it became abundantly clear that the cash, or spot, price for a commodity is no longer established by competitive trading, or by the free market as it is conventionally described. The January 5, 1976, memorandum from Russell McDonald to Edward Nowicki (enclosed as Attachment 2) shows that in one commodity after another the spot price quoted is "not reliable." In practice, the cash price for many commodities is determined by the commodity futures market, or by some process which substitutes speculative judgment for the collective opinion of numerous buyers and sellers of the actual commodity. If the cash price of commodities, an issue which is of great importance to consumers, processors and producers, is to be affected by options, a speculative process which is one step further removed from the marketplace than is futures trading, then the dangers need far more study and consideration than the

Committee has given.

It is not an adequate discharge of public responsibility to say that if a problem develops, then the Commission can act to eliminate option trading. This is not an issue which affects a few individuals who trade in options, it is a danger which could do serious economic harm to millions.

The lesson of history demonstrates that the benefits of commodity trading to society are optional. There are other means of assuring stable prices and adequate commodity supplies. Consumers, processors, and producers are not dependent upon futures trading to insure an adequate and stable food system, and the recommendations of the Committee may well cause Congress to look to other alternatives.

That is not what I would recommend, nor is it obviously what the Committee would want. Yet it may be the consequence of their recommendations.

I recommend the Commission ban trading in commodity options until some greater need or purpose is evident than what has been advanced so far.

[Attachment not reproduced. CCH.]

ADDITIONAL VIEWS OF
Philip C. Olsson

While I support the Committee's basic recommendations that commodity options not be prohibited, it is very important that commodity options trading be subject to regulation at least as strict as that which the CFTC provides for futures trading.[1] Therefore, the Commission should establish a designation procedure for option contracts which embodies public interest and economic purpose criteria similar to those established for the designation of futures contracts. In addition, if off exchange trading is permitted in dealer options, the Commission should recognize that a greater degree of regulation may be required than where futures contracts are traded by open-outcry on regulated exchanged.

The history of options trading regulation summarized in Exhibit I to this report demonstrates that Congress has in the past perceived option transactions as "gambling" and as vulnerable to manipulation.[2] Options trading has been banned since 1936 in most domestic agricultural commodities.[3] The collapse of the Goldstein, Samuelson firm in 1972 demonstrated the hazards of unregulated, off-exchange option trading.[4] This history confirms that option regulation should be no less strict than futures contract regulation.

1/ In filing these separate views, I must acknowledge that I was not a member of the Options Subcommittee and that I was able to participate only briefly in the full committee review of the options material.

2/ Brief History of Option Trading in the United States, May 10, 1976, pp. 88, 90, 91.

3/ Id. at 94.

4/ Id. at 96.

A new "public interest" section was added to the Commodity Exchange Act in 1974, conditioning the authorization of futures trading in any commodity as follows:

> (g) When such board of trade demonstrates that transactions for future delivery in the commodity for which designation as a contract market is sought will not be contrary to the public interest. 7 U.S.C. §7(g)

The Commission has moved to implement this language by issuing CFTC Guideline No. 1 (May 13, 1975) requiring that boards of trade demonstrate not only that "transactions for future delivery in the commodity will not be contrary to the public interest", but also that any such contract "meets the economic purpose test". To meet this economic purpose test, a board of trade must provide evidence that:

> "more than occasional use of the contract for hedging or price basing exists, or can reasonable be expected to exist." 6/

The Advisory Committee expressed itself as

> . . . strongly of the view that it is not necessary to demonstrate an improvement or betterment of the public interest in order to permit option trading, any more than it is necessary to establish an affirmative justification for engaging in any other form of economic activity. Rather, it should simply be required that the public interest will not be so adversely affected by such trading that there is sufficient reason to prohibit it. [emphasis supplied] 7/

The conditions which must be met before the futures contract may be traded are stricter than the Advisory Committee's recommendations for option contracts. The preconditions for futures contract designation allow for no adverse affect on the public interest. Option contracts should be subject to

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5/ CCH Commodity Futures Law Reports, ¶6145.

6/ Id

7/ See p.15 of this report.

conditions at least as strict.

Strict conditions for designation are particularly necessary for dealer options traded off regulated exchanges. Since this trading will take place outside of recognized markets, it will be difficult for the Commission to monitor. Therefore, it is important that, prior to authorizing issuance of any dealer option, the Commission ascertain that the option contract does serve an economic purpose and is not contrary to the public interest. Contracts which serve no economic purpose may well be the kind of "gambling" transactions which Congress criticized during the 30's. The CFTC should not provide an umbrella for transactions lacking public interest or economic purpose, absent clear Congressional intent to the contrary.

EXHIBIT "D" TO AFFIDAVIT OF JOHN FORMA

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NUMBER 29 AUGUST 20, 1976 PART II

COMMODITY FUTURES TRADING PROFESSIONALS

Advisory Committee
Report to the
Commodity Futures Trading Commission

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About This Report

This Special Report contains the recommendations and conclusions of the Commodity Futures Trading Commission's Advisory Committee on Commodity Futures Trading Professionals. This Advisory Committee was established by the CFTC to consider and submit reports and recommendations on the standards of regulation which should be applied to domestic and foreign futures trading professionals.

Included in the category of futures trading professionals for the purposes of this Advisory Committee were commodity trading advisors, commodity pool operators, futures commission merchants, floor brokers, and associated persons.

Under the chairmanship of Commissioner Robert L. Martin, the Advisory Committee examined the definition, role and functions of the futures trading professional; reviewed recordkeeping, reporting, financial responsibility and fitness requirements; discussed the regulation of non-member FCM's; and considered the standards for adequate customer protection.

August, 1976

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INTRODUCTION

On August 5, 1975, the Commodity Futures Trading Commission established an advisory committee program comprised of four separate advisory committees of limited duration. In establishing the Advisory Committee on Commodity Futures Trading Professionals ("Committee"), the Commission stated that the Committee would be asked to consider -- and submit reports and recommendations to the Commission on -- the standards for regulation under the Commodity Exchange Act ("Act") of domestic and foreign commodity futures trading professionals (principally, commodity trading advisors, commodity pool operators, futures commission merchants, persons associated therewith and floor brokers).[1] The Commission assigned the following subjects to the Committee:

(1) The definition, role and function of commodity futures trading professionals;

(2) Recordkeeping, reporting and financial responsibility requirements for such professionals;

(3) Training and fitness standards for trading professionals;

(4) Regulation of futures commission merchants that are not members of contract markets; and

(5) Standards for protecting customers of trading professionals, including:

(i) Information needs of futures traders;

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[1] See 40 Fed. Reg. 32866

(ii) Responsibilities of trading professionals to their customers; suitabiity/know your customer duties; and customers' rights.

The Committee, which was chaired by Commissioner Robert L. Martin of the Commodity Futures Trading Commission, discussed these issues at eight meetings, which were held on November 18, 1975, January 6, 1976, January 27, 1976, February 17, 1976, March 25 and 26, 1976, April 20, 1976 and June 10, 1976. The Committee heard testimony from members of the public at a number of the meetings.

THE COMMITTEE MEMBERS [2]

John W. Clagett, President
Futures Industry Association
New York, New York
(Past President, New York Mercantile Exchange)

Stephen Greenberg
Senior Vice President
Bache & Co., Inc.
New York, New York
Chairman, Cotton Exchange
President, Wool Associates
(Past Chairman, Chicago Mercantile Exchange)

William M. Phelan, Attorney
Chicago, Illinois
(Past Vice-President, Audits & Investigations, Chicago Mercantile Exchange)

Robert C. Liebenow, President
Corn Refiners Association, Inc.
(Past President, Chicago Board of Trade)

Alvin E. Oliver, Executive Vice President
National Grain & Feed Association
Washington, D. C.

James Plaxico, Professor of Agricultural Economics
Oklahoma State University
Stillwater, Oklahoma

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[2] Mr. H. W. Harrington withdrew as a member because of personal health reasons.

Wayne A. Randall, Manager
Training and Examinations
New York Stock Exchange
New York, New York

Robert L. Searles
Member, Minneapolis
Grain Exchange
Minneapolis, Minnesota

James F. Shea
Floor Broker
Chicago Board of Trade
Chicago, Illinois

Morton I. Sosland
President
Sosland Companies, Inc.
Kansas City, Mo.
Editor and Publisher
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Hornblower & Weeks,
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Boston, Mass.

Kenneth L. Sullet
President and Creative Director
Sullet & Carpenter Advertising
Agency, Inc.
Los Angeles, California

Theodore Thomte, President
Thomte-Roper, Inc.
(Operator of Commodity Pools)
Member, Commodity Exchange, Inc.

COMMITTEE STAFF

R. David Gary, Assistant
to the Committee Chairman
(Special Assistant to
Commissioner Robert L. Martin)

Frederick L. White
Counsel to the Committee
(Special Counsel, Division of
Trading & Markets, CFTC)

Miss Maureen Lally (Attorney, Division of Trading & Markets, CFTC) and Mr. Charles Hord (Attorney, Office of the General Counsel, CFTC) also assisted the Committee.

Administrative Staff

Dorothy Foster
Loraine Leonard
Leslie Sorg
Vicki Spears

SUMMARY OF MAJOR RECOMMENDATIONS AND CONCLUSION

1. General Comment. A recurring theme in the Committee's discussions of the role and responsibilities of futures professionals was the public's lack of understanding--and often its misunderstanding--of the commodity futures markets. The image many people have of the industry is limited to the tumultous activity of the pit. Members of the public have scant awareness of the vital economic functions performed by the futures markets, or of the impact of those markets on their everyday lives. Popular myths about futures contracts abound. These misconceptions, when coupled with the deceiving sales tactics used by some members of the commodity futures industry, undermine the public's confidence in the industry and in the integrity of the markets. This situation is exacerbated by inevitable comparisons to the securities industry -- which has benefited from the 40-year presence of a vigorous independent regulatory agency, an active self-regulatory association, a dominant exchange and federal insurance of brokerage accounts. None of these benefits -- which are important to the public's perception of an industry -- has been available to the commodities industry.

Accordingly, notwithstanding the increasing volume of futures trading, there is a regretable lack of public confidence in the futures markets. If those markets are to remain active and healthy, that confidence must be increased; the raising of standards for professionals in the commodities industry is an essential step in achieving that goal. While the main purpose of the Committee's recommendations is to protect the customers and clients of futures professionals, these recommendations also have been formulated with a view to increasing confidence in the futures markets. For this reason, the Committee views its recommendations as serving the long-run interests of the futures professionals, as well as their customers and clients.

2. Disclosure of Risk. New commodities traders are too often unaware of the substantial [illegible] of loss inherent in futures trading. Attracted to futures trading by low margins, high leverage, and volatile prices, the new and [illegible] commodities trader often fails to realize that these [illegible] can lead to sharp losses as well as large and rapid gains. [illegible]gly, it is absolutely essential that commodity futures professionals who deal with the public be required to disclose to each new customer the substantial risk of loss that generally exists in futures trading. This disclosure must be in writing; it must be concise and understandable to the inexperienced trader; and the disclosure document must be conspicuously brought to the customer's full attention when it is transmitted to him.

It is particularly important that the disclosure document be brief --preferable one page. A lengthy document simply will not be carefully read by many customers. The Commission should assist in the development of an approved uniform risk disclosure statement.

Risk disclosure by futures professionals must be accompanied by a vigorous program of educating the public about the futures markets. While a risk disclosure document will help to correct misunderstandings of the futures markets, education will help to prevent such misunderstandings from arising in the first place.

3. Disclosure vs. Prohibition. In its discussions, the Committee considered a number of practices which, while lawful, were nevertheless disturbing to the members of the Committee. The Committee generally felt that regulation of these practices should be accomplished by way of disclosure rather than through prohibition or restriction.

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4. Qualifications Standards for Associated Persons. Many of the approximately 23,000 registered associated persons (APs) are undoubtedly well-trained by their firms and are highly competent professionals. But not every futures commission merchant (FCM) has a training program and not every exchange requires the account executives employed by its member-FCMs to pass a commodities examination. Moreover, there are some 887 registered APs who are employed by non-member FCMs. Accordingly, there are undoubtedly a number of AP registrants who are not qualified to handle customer accounts.

This situation can be remedied only by requiring all applicants for AP registration to pass a properly-developed and sufficiently strict commodities examination. The examination should be developed and administered by the futures industry rather than the Commission (although it must, of course, meet CFTC approval); it must be based on analyses of the tasks performed by APs (with separate task analyses for identifiable categories of APs); testing experts should be retained to assist in the writing of exam questions; and the exam should be continuously monitored for relevancy and adequacy. A proper examination should obviate the need for a training requirement, as the FCMs will then find that if their prospective employees are to pass the exam, they must train them properly within their own firms or enroll them in effective commercial training programs.

5. Commodity Trading Advisors. Trading advisors have a significant effect upon the futures industry because the public's perception of futures trading is to a large extent shaped by their sales brochures, newspaper advertising, seminars and broadcast communications. In view

of the public interest in promoting both a proper understanding of the futures markets and public confidence in the industry, and the substantial harm that could easily be caused by improper advertising, it is essential that the Commission actively supervise the advertising practices of trading advisors.

6. Commodity Pool Operators.

a. Generally. While the amount of trading by commodity pools is, at present, probably small in relation to other types of trading, it seems likely that the amount of funds under management by pool operators will increase substantially.[3] In view of the young but rapidly-growing nature of the pool industry -- together with the fact that the potential for abuse in the industry is quite high[4] -- the Commission should give priority to the development of pool operator regulations. A commodity pool abuse could seriously jeopardize the development of this important industry -- which brings much-needed speculative funds into the market -- and could injure the entire futures industry.

b. Segregation of funds. Like FCMs, pool operators handle and control large amounts of funds received from others for the purpose of futures trading. Yet unlike FCMs, pool operators are not presently regulated by the CFTC in this area of their activities. Since the potential for conversion, misappropriation or mishandling of the pool's funds by the operator clearly exists, it is vital that the Commission promptly

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3/ The rough estimate supplied to the Committee is that pool operators currently manage about $75,000,000. [Assuming that 50% of those funds are committed to original margin, the pools could have more than a quarter of a billion dollars in futures market positions.] The number of registered pool operators has increased from 225 in September 1975 to 287 in January 1976 to 370 as of April 28, 1976.

4/ See p. 26, *infra*.

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adopt regulations that provide pool participants with basically the same protections that its rules provide to FCM customers.[5] The Commission must adopt rules that prohibit pool operators from commingling the pool's assets with their own assets[6] and that require pool operators to maintain the pool's funds, securities and other property in a safe manner. And, to enforce these rules, the Commission must require pool operators to keep such records as are necessary in order for the Commission's auditors to determine whether the pool operator is dealing fairly with the pool's assets.

c. Disclosure. Pool operators must be required to disclose to prospective participants, among other things, the nature of futures trading; the qualifications of the operator and any trading manager he may retain; complete information about the operation of the pool; fees; and the affiliations or financial arrangements (if any) between the pool operator and any FCM with which the pool will maintain an account. There is no valid reason why the disclosure document must be lengthy; indeed, like the FCM risk disclosure statement,[7] it is vital that the document be brief and understandable.

7. Advertising of Performance. Any advertisement by a commodity professional that refers to its performance in the futures market, or that of any pools or accounts it manages, must give a true and complete picture of that performance. For example, if a pool operator advertises the performance of a successful pool it operates, it must — in the same advertisement — disclose the performance of every pool it operates —

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[5] Of course, to the extent that pools deposit their funds with FCMs, pool participants receive some protections from the Commission's segregation rules. However, the funds that are not so deposited, are relatively unprotected.

[6] As discussed infra p. 27, these rules should be drafted so as to permit pool operators to participate in their own pools — an act that might otherwise be technically viewed as "commingling."

[7] See p. 2, supra.

especially if those other pools have been less successful. The performance figures must cover, at the least, the past year's trading. Similarly, if a trading advisor refers in his advertising to the performance of any accounts he manages, or how well a particular recommendation he made has fared, he must, in that same advertisement, disclose the performance -- over at least the past year -- of all the other accounts he manages or recommendations he made. And, if an FCM advertises the performance of any accounts it manages (either an individual discretionary account, managed account or guided account), it must disclose the performance, for at least the past year, of all such accounts.

Performance advertising must also disclose the amount of funds in the pool or account in question and the percentage of those funds customarily committed as original margin.

Since short-term results in futures trading can be highly misleading, futures professionals should be prohibited from advertising performance that covers less than one year's trading. Advertising of theoretical, hypothetical or simulated results should be flatly prohibited, as it is simply too easy to manufacture impressive but fictitious statistics.

8. Floor brokers. With one member dissenting, the Committee concluded that financial and other standards for floor brokers should be set by the exchanges rather than the Commission. The majority's reasoning was based on the fact that floor brokers generally do not deal with the public; that there have been apparently no instances in which floor broker insolvencies have adversely affected the public; and on the fact that the manner in which floor brokers operate generally differs from exchange to exchange.

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9. Auditing by Certified Public Accountants. The annual financial statements filed with the Commission by FCMs must be certified by an independent public accountant. The Commission should require pool operators annually to furnish pool participants with a certified financial statement, unless the pool is a small, essentially private enterprise and 3/4 of the participants register a preference for an uncertified statement.

While the Committee recognizes that an independent audit can be a substantial expense, the Committee felt that any alternative was unacceptable. FCMs and large pool operators handle substantial amounts of funds of others; the opportunity for misuse of those funds is ever-present; and the Commission may be unable to fulfill its obligations to assist FCMs and pools.

FUTURES COMMISSION MERCHANTS

A. Introduction

A futures commission merchant (FCM) is basically any firm that solicits or accepts orders for commodity futures contracts traded on an exchange and which, as part of that business, accepts customer funds to margin those trades.[8/] It is important to recognize that there are several contrasting types of FCMs — large companies (often public) with many branch offices vs. smaller firms with few or no branch offices; merchant firms that regularly deal in cas[illegible]odities vs. firms that engage only in customer business; FCMs that are also engaged in the securities business (and are often stock exchange members) vs. FCMs that are solely commodities brokers;[9/] and firms that are members of commodity exchanges vs. those that are non-members. These contrasts present a number of regulatory problems, as discussed below.

[8/] The statutory definition is contained in section 2(a)(1) of the Act:

> " . . . . The words 'futures commission merchant' shall mean and include individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom. . . ."

The main requirements presently applicable to FCMs are: the speculative trading and position limits (sec. 4a of the Act and CFTC rules 150.1-150.11); the antifraud provisions (sec 4b); the registration provisions (sec. 4f(1)); the provisions relating to the segregation of funds (sec. 4d(2) and rules 1.20-1.29); minimum financial standards (sec. 4f(2) and rule 1.17); and the reporting and recordkeeping provisions (sec. 4g and rules 1.10, 1.18 and 1.31 - 1.37 and 17.00-17.03).

[9/] Approximately 50 of the 287 registered FCMs are securities broker-dealers.

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As of April 28, 1976, there were 287 FCMs registered with the Commission, 234 of which were members of contract markets (designated commodity exchanges).

B. Recommendations and Discussion

1. Disclosure. FCMs must be required to furnish each new commodities customer with a clear and concise written statement (preferably one page) explaining the risks inherent in commodity futures trading, particularly the risk to uncommitted capital. The FCM should be required promptly to obtain from the customer a written acknowledgment that he has received the risk disclosure document.

DISCUSSION: The new customer who has never traded commodities previously is unlikely to be familiar with futures trading, although he may have heard accounts of large and rapid trading profits made in the futures markets. It is essential that, immediately upon opening an account, he be advised by the FCM, in writing,[10/] of the risks of futures trading. Specifically, he should be informed in writing that futures prices are subject to large and rapid fluctuations; that the potential for profit (and loss) is directly related to the degree of leverage; and that the same high leverage which creates the potential for large profits can also lead to large losses. Further, the customer should be informed about original and variation (or "maintenance") margin; the differences in margin requirements for different commodities; daily price limits; the possibility of successive days of limit trading; and the fact that successive limit days can vitiate stop-loss orders.

It would be highly desirable if the risk disclosure statement were a uniform document that could be used by trading advisors and pool

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[10/] The document should be carefully brought to the customer's attention when it is furnished to him. It must not be inserted in a batch of documents that are routinely sent to new customers.

operators as well.[11] The Commission should work with the futures industry to develop such a document. The Committee is concerned that if the document is not standardized it will become unnecessarily lengthy and complex and thereby lose much of its value.

The purpose of the acknowledgment requirement is twofold -- to ensure the transmission of the document to the customer and to provide a method by which the FCM can establish that it transmitted the document.

2. Customer Protection

a. Know your customer. An FCM must have a continuing general knowledge of each customer, including his overall financial situation, trading objectives and suitability to engage in futures trading.

DISCUSSION: Commission rule 1.37, which requires FCMs to ascertain the name, address and occupation of each account-holder, must be broadened to require FCMs to obtain from each customer complete information as to his income, net worth, number of dependents, etc. FCMs must be required to use reasonable diligence to verify the accuracy of the information furnished by the customer, although it should be recognized that: (i) it may be somewhat more difficult for an FCM to know his customer than for a securities broker-dealer, since there is probably less face-to-face contact between customer and broker in the commodities business than in the securities business, and (ii) it is more difficult for an FCM to know a foreign customer than a domestic customer.

The FCM's duty to know his customer must be a continuing one. A customer's financial situation and capacity for risk taking may change from what it was when he opened the account.

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[11] See pp __, infra.

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FCMs should know their customers not only for the purpose of making suitable recommendations but also to avoid situations in which a defaulting customer might jeopardize the entire firm and its other customers. For this latter reason, FCMs should determine if their substantial customers are trading with other firms, and — if so — to what extent.[12]

b. Suitability. An FCM must have a reasonable ground for believing that each recommendation made by it to a customer is suitable in light of the customer's financial condition, objectives, etc.

DISCUSSION: Suitability is of particular importance in commodities trading because of the wide varieties of trading programs that are available to customers. For example, a series of spread trades may be appropriate for a conservative trader whereas an aggressive program of speculation in a volatile contract may be entirely unsuitable.

c. Required minimums. The CFTC should not establish a minimum net worth requirement that a customer must meet in order to maintain an account with an FCM.

DISCUSSION: A customer's suitability to trade futures does not depend on his net worth. First, there are many different kinds of trading programs in which a customer may engage — ranging from the highly conservative to the very agressive. Second, net worth is only one element of a customer's capacity for risk-taking; an individual with a relatively small net worth but high income and few dependents is probably more suited to futures trading than an individual with a higher net worth but relatively low income and several dependents.

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[12] The FCM will, however, have to rely solely upon the customer for the accuracy of this information in many cases.

d. Discretionary accounts.[13]

(i) Minimum size. The Commission should prescribe a minimum size (approximately $3,750 - $5,000) for discretionary accounts.

(ii) Identification of Orders. Orders entered for discretionary accounts should be designated so as to indicate whether the particular order was entered pursuant to discretionary authority or not.

(iii) Authorization. FCMs should not be permitted to accept or carry a discretionary account unless the customer has given prior written authorization to the FCM that defines precisely the terms of the discretion and terminates within one year, subject to one year renewals. Approval of the handling of the account by a supervisory employee of the firm should also be mandatory.

e. Supervision of associated persons. Appropriate standards should be established for the supervision by FCMs of their associated persons in the handling of customer accounts.

DISCUSSION: While the standards must be meaningful, they should be set at a level that the small FCMs can meet. Among the standards should be: review by supervisory personnel of all account errors; prior approval of all inter-account transfers; periodic review of purchase and sale statements; and review of the ratio of commissions to net equity in the account.

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[13] With respect to the issue of when an order should be considered discretionary in nature, one of the members of the Committee disagreed with the generally-prevailing view that a commodities order should be deemed discretionary if it does not precisely specify time and price. In his opinion an order for the purchase or sale of a particular contract (or particular number of contracts) on a specified day should not be considered discretionary — just as such an order for securities is not discretionary. The majority felt that because of the volatility of futures prices, prevailing view is correct. There was agreement, however, that there should be uniformity among the exchanges as to what type of order should be considered discretionary; such uniformity does not currently exist.

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f. Churning. Churning (excessive trading in customer accounts) should be dealt with on a case-by-case basis, as churning standards would be difficult to develop.

DISCUSSION: Churning is an extremely harmful practice, although unfortunately one that is difficult to define or detect. The Commission should strictly enforce the anti-churning provisions of the Act. An important element in determining whether an account has been churned is the customer's stated objective (e.g., did the customer wish to engage in day trading or only in long-term trades). Another factor is the ratio of commissions to equity in the account. It is unlikely that the churning standards developed in securities cases are applicable to commodities accounts.

3. Competency Examinations. Principals of FCMs who are not registered as associated persons should be required to pass a competency examination as a prerequisite of their being associated with an FCM.

DISCUSSION: The Committee's conclusions concerning competency examinations are set forth on page 45.

4. Financial standards.

DISCUSSION: In the interest of fostering self-regulation, and because the exchanges can deal swiftly with FCM financial problems, it would be desirable if the financial standards for FCMs were established by the exchanges. This could, however, lead to the confusing and undesirable situation of differing financial standards among the exchanges and differing methods of computing financial status. Moreover, the Commission would still find it necessary to maintain (as it currently does) its own financial standards for those FCMs that are non-members of exchanges and those member firms that do not belong to exchanges with CFTC-approved financial requirements. Perhaps the best solution would be for the Commission to prescribe a minimum financial standard that all FCMs must meet -- along with a uniform method of computing financial condition -- with the exchanges being permitted to raise the minimum for their members. Similarly, if non-member FCMs joined a Title III organization, that self-regulatory body could raise the minimum for its members. Whatever system is used, it is vital to have a uniform method of computing financial condition.

Several members of the Committee expressed concern about the possibility that FCMs which are clearing members of more than one exchange may be using the same capital reserve to satisfy the financial requirements of different exchanges. These members felt that such FCMs should have a separate reserve for each exchange. Other members of the Committee did not believe this was a problem, citing the close monitoring of clearing members and the safety factors.

It is important that the minimum financial (and other) standards to which non-member FCMs are subject be as high as those to which member-FCMs are subject. Otherwise, member-FCMs may find it advantageous to give up their memberships. The customers of non-member firms should be afforded the same basic protections as are customers of member firms.

5. Auditing of FCM financial Statements. The Commission must require that the year-end financial statements submitted by FCMs be certified by an independent public accountant. The Commission must develop standards and guidelines to promote uniformity among FCM audits. Since a number of FCMs are also securities brokers-dealers, and thus subject to SEC auditing standards, the Commission's audit requirements should be coordinated with those of the SEC to the maximum extent feasible. See p. 53, infra. The Committee urges the Commission to structure its audit program so that the CFTC audit staff does not duplicate the work of the FCM's outside auditors.

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6. Record retention. The general requirement of Commission Rule 1.31 that all required records be retained for 5 years (2 year's on-premises) should be changed to a 3 year requirement (1 year on-premises). In addition, the required retention period for the following FCM records should be the greater of: (i) 1 year (on-premises) or (ii) the period starting with the most recent CFTC audit of the FCM:

a. The daily record of funds and property required to be segregated (See Commission Rule 1.32).
b. Confirmation of trades for customers whose accounts are controlled by other persons (Rule 1.33a(a)).
c. The monthly "point balances" of customers' open positions (Rule 1.34).
d. All futures and cash transactions (Rule 1.35(a)).
e. Financial ledgers, customers' transactions and daily journals (Rule 1.35(b)).
f. The name, address and occupation of each account holder (Rule 1.37).
g. Purchase and sale statements (Rule 1.35(a)).

7. Insurance of commodity futures accounts. The Commission should undertake a thorough study of the need for and cost of an insurance program and hold public hearings on the matter.

DISCUSSION: In order to determine whether an insurance program should be established, it is necessary to analyze such matters as:

- the incidence of FCM insolvencies;
- the adequacy of exchange trust funds;
- the cost of the program;
- the amount of coverage that should be afforded;
- how the program would be financed and administered;

- the amount of reserves that should be available to the program;
- who should be a member;
- whether private insurance would be feasible; and
- whether commodity account insurance could be integrated with the securities account insurance provided by the Securities Investor Protection Corporation.

Because of the complexity of many of these issues and the fact that data is not yet available in a number of these areas, the Committee was unable to formulate recommendations as to the need for insurance. The Committee does recommend that the Commission study these matters and hold public hearings.

In deciding whether to establish an insurance program, the Commission should give consideration to the evidently low incidence of FCM insolvencies and the financial protections that the Commission's segregation rules provide to FCM customers. On the other hand, there is a public interest in promoting confidence in the futures industry and it seems likely that an insurance program -- particularly when coupled with an active program of education -- would yield benefits in that regard.

Several members of the Committee believed strongly that there is a definite need for commodity account insurance, and that a program should be established unless the costs are truly prohibitive. In their view, the existence of securities account insurance and the lack of commodities account insurance creates a disparity that lessens public confidence in the futures industry and may be depriving the commodity markets of necessary speculative funds.

8. FCM Affiliates of Merchant Firms. Firms that are subsidiaries of, or are otherwise affiliated, with firms that engage in cash commodities transactions should maintain a rigid separation from the parent firm.

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DISCUSSION: It would of course be improper for an FCM that was a subsidiary of a merchant firm to issue futures market recommendations that were designed to benefit the parent firm's own cash or futures positions.[14/] The Commission should therefore make sure that, in the case of such FCMs, there is strict separation of the FCM's operations from the parent's operations in the cash and futures markets. Specifically, commodity-related information possessed by the parent firm -- particularly information about its own cash or futures transactions -- should be isolated from those individuals responsible for the FCM's futures market recommendations.

Implicit in the Committee's recommendation is its belief that it is not per se improper for an FCM to be affiliated with a merchant firm whose activities are entirely separate from those of the FCM. The Committee thus regards its recommendation as preventive rather than corrective; the Committee is unaware of actual abuses in this area.

[14/] It would also be improper for such an FCM to use its affiliation as a device to attract customers -- that is, by suggesting that the customers would benefit from the parent firm's special inside knowledge of the cash or futures market.

ASSOCIATED PERSONS

A. Introduction

An "associated person" (AP) is basically any FCM partner, officer or non-clerical employee who solicits or accepts customers' orders or who supervises any person so engaged.[15/] APs are required to be registered with the Commission, unless they are already registered as a floor broker or FCM.[16/]

As of May 15, 1976, there were 22,700 individuals registered with the Commission as APs, of which 887 were associated with non-member FCMs and 2,183 were not associated with any FCM.

B. Recommendations and Discussions

1. Competency examinations. The level of competence among associated persons is clearly in need of being upgraded. Accordingly, by the earliest feasible date, all new applicants for registration as associated person must be required to pass a proficiency examination as a condition of registration.

DISCUSSION: The Committee's conclusions regarding proficiency examinations are set forth on pp. 45-47.

[15/] The definition of the term associated person is contained in section 1.3(aa) of the Commission's rules, which reads as follows:

> "This term means any person who (as provided in section 4k of the Act) is associated with any futures commission merchant or with any agent of a futures commission merchant as a partner, officer or employee (or any person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation or acceptance of customers' orders (other than in a clerical capacity) or (ii) the supervision of any person or persons so engaged."

[16/] Section 4k(1). The exemption of registered floor brokers does not seem wholly warranted in view of the significant differences between the responsibilities of floor brokers and APs.

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2. Qualifications standards. The Commission should not establish qualifications requirements (other than an examination) for associated persons. (See p. 48.)

3. Registration. Applicants for registration as associated person should be sponsored by the FCM with which they will be associated.

DISCUSSION: The important process of raising the qualification standards of associated persons will be seriously impeded if the registration of these individuals is not granted through the employing FCM firm.[17] Firms not charged with sponsoring their employees for registration are not required to make an investment in their training. Consequently, the employing firms may not develop a responsibility for, or an incentive toward developing, training programs. Nor do firms feel as much concern for the actions of employees in whose registration they are not required to participate and for whom they are not required to account when they leave the firm.

Associated persons who are registered with the Commission independently of their firms, who may transfer freely from one firm to another without having to receive clearance through the Commission, and who realize the Commission may not know for whom they have worked or are working, develop little fear of the consequences which their actions with one firm may have on their ability to transfer to another. Any affinity or allegiance to the firm generated by a training program is completely lacking.

Little real progress in the development of realistic qualification standards can be expected until performance during the tenure of registration is made a common interest of the associated person and his employer.

17/ If the wording of the Act does not permit the Commission to register APs through their firms, the Commission should seek an amendment that would permit it to do so.

Accordingly, if a registered associated person terminates his association with the employing FCM, he should be required to re-register with the Commission before joining another FCM. The Commission should, however, establish a grace period -- perhaps 90 days -- within which the AP may join another firm without having to re-register.

4. Scope of the Definition. Every employee of an FCM that shares directly in commissions should be deemed an associated person. Employees of FCMs who act solely as "phonemen" on the exchange floor are functioning in a clerical capacity and therefore are not associated persons.

DISCUSSION: FCMs occasionally retain individuals whose function is to direct customers to the firm. While these "introducers" or "openers" might not handle orders, they should be required to register as associated persons if their compensation from the FCM is based to any extent upon commission revenues generated by the account. It is the incentive of sharing in commissions that creates a potential for misconduct and thus these persons should be required to register.

5. Personal trading. The trading of futures by associated persons for their own accounts should be closely supervised by the employing FCM.

6. Foreign APs. Associated persons employed outside the United States by FCMs or their agents basically should be subject to the same requirements as domestic associated persons.

FLOOR BROKERS

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FLOOR BROKERS

A. Introduction

A floor broker is basically a person who executes futures trades for the accounts of others on the trading floor of a contract market.[18] As of April 28, 1976, there were 2,347 persons registered with the Commission as floor brokers.

B. Recommendations and Discussion

1. Financial requirements. Floor brokers should be required to meet appropriate minimum financial standards. In view of the fact that a floor broker's degree of financial exposure and risk of loss may vary from exchange to exchange, and the apparent absence of situations in which floor broker insolvencies have adversely affected the public, those standards should be set by the exchanges rather than the Commission. One member of the Committee disagreed for the reasons set forth on p. __. In his view, the Commission should set the standards.

DISCUSSION: After executing an order, a floor broker must "give up" the name of a clearing member. On some exchanges, the floor broker is liable for performance of the futures contract until the clearing member accepts the transaction. On other exchanges, each floor broker must be "qualified" by a clearing member, who is at all times liable for the performance of futures transactions engaged in by the floor broker.

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[18] The statutory definition is contained in section 2a(1) of the Act:

> ". . . . The word 'floor broker' shall mean any person who, in or surrounding any 'pit,' 'ring,' 'post,' or other place provided by a contract market for the meeting of persons similarly engaged, shall purchase or sell for any other person any commodity for future delivery on or subject to the rules of any contract market . . . ."

On those exchanges where the floor broker is liable for performance pending acceptance of his trade, he should be required by the exchange either to maintain an appropriate amount of capital or to obtain a guarantee from a suitably capitalized member firm.[19] In the latter situation, it is vital that the exchange monitor closely the ability of the guarantor to fullfill his guarantee -- unless of course the guarantor is a clearing member, in which case his financial condition is subject to daily scrutiny. Those guarantors who are not clearing members should be required by the exchanges to report to the exchange any material change in their financial condition, and guarantors of more than one floor broker or trader should be monitored particularly case.[20] Exchanges should be aware that the soundness of a guarantee can change dramatically over the course of just a few trading sessions.

One member of the Committee disagred with the Committee's view that financial standards for floor brokers should be set by the exchanges. In his opinion, the exchanges have not shown a willingness to establish adequate standards and, accordingly, the standards should be set by the Commission. He referred to the exchanges' practice of permitting floor brokers who trade for their own account to maintain debits in their accounts with clearing members, a practice that results in the extension of credit by the clearing member to the broker. In

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[19] The exchange would not have sufficient control over a non-member.

The exchanges should not, however, make it overly difficult for individuals who do not have a large net worth, but who are otherwise well-qualified, to enter the floor broker profession. In fact, the exchanges should be encouraged by the Commission to establish procedures for enabling such individuals to obtain the financial backing needed to operate as a floor broker.

[20] The guarantor should not be permitted to use the same reserve to guarantee more than one floor broker. For example, if an exchange requires a $100,000 guarantee, a member who guarantees two floor brokers should be required to have a net worth of $200,000.

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his view, this creates a potential for improper [illegible]ices by floor brokers. The financial pressure of maintaining a debit balance creates a temptation for the floor broker to take advantage of his customers (for example, by placing a profitable trade in his own account) or possibly can lead to the triggering of stop-loss orders.

2. Dual trading. Floor brokers generally should be permitted to trade for their own account, subject to close inspection and monitoring by the exchanges.

DISCUSSION: Since the Commission is currently engaged in a study of dual trading, the Committee discussed this complex matter only briefly. The Committee's view that dual trading should be permitted (on an exchange-supervised basis) was based on the following factors: dual trading promotes market liquidity; some customers prefer a floor broker-trader to a floor broker who is solely an executor of orders; dual trading permits floor brokers to "work-out" mistakes; execution of spread (or straddle) orders would be inhibited if dual trading were to be prohibited; and such a prohibition would reduce the number of floor brokers.

3. Competency standards. Competency standards should be established by the exchanges.

DISCUSSION: Since trading practices differ from exchange to exchange, problems may be encountered in developing an effective, industry-wide floor broker examination. For this reason, and because all floor brokers are subject to exchange regulation, the Commission should require each exchange to establish appropriate competency requirements — examinations, training, orientation periods, etc. — for its floor brokers. If the Commission determines that the exchanges are not complying with this requirement, it should then establish its own proficiency requirements for floor brokers.

The exchanges should perhaps require new floor brokers to undergo an orientation or familiarization period on the exchange floor before handling orders. The length of such a period should be at the discretion of the exchange and should depend upon the speed with which the floor broker becomes proficient in the exchange's trading procedures. The informal system that exists on some trading floors by which floor brokers tend to train newer members is desirable and should be encouraged.

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COMMODITY POOL OPERATORS

A. Introduction

A commodity pool operator is basically any person who forms or manages an investment enterprise that engages in futures trading.[21] Some pool operators are strictly managers of the commodity pool while others both manage and make trading decisions for the pool. The latter type of operator may be a trading advisor, although probably not required to register.[22] While the amount of trading by commodity pools is, at present, probably small in relation to other types of trading, it seems likely that the amount of funds under management by commodity pool operators will increase substantially. The Commission should give high priority to the development of pool operator regulations, particularly in commodity pools, the Commission should not bar pools from trading in interests other than futures (for example, securities and real estate). Pools should be free to engage in such activities so long as the participants are apprised of the possibility of the activity when they purchase their interest in the pool.[24/]

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[21] The statutory definition of the term is contained in Section 2(a)(1) of the Act:

> ". . . . The term 'commodity pool operator' shall mean any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definition as the Commission may specify by rule or regulation or by order. . . ."

[22] The Commission has proposed a rule (§1.54) which generally excludes from the definition of commodity trading advisor any registered commodity pool operator whose trading advisory services are furnished solely to the commodity pool(s) it operates. In proposing the exclusion, the Commission stated that, pending its decision on whether to adopt the rule, it would not require those registered pool operators who qualified under the proposed exclusion to register as trading advisors. 40 Fed. Reg. 29090.

2. Recordkeeping. Pool operators must be required to keep such records as are necessary in order for the Commission to be able to determine whether the pool operator is dealing properly with the pool's assets.

DISCUSSION: The necessary records would probably include: all purchases and sales of futures contracts; the profits and losses realized on closed positions; unrealized profits and losses on open positions; margin deposits; funds received from pool participants; distributions to and withdrawals by participants; expenses (especially management and advisory fees); and interest income. In the interest of reducing the burden and cost of recordkeeping, the Commission should explore the possibility of whether the monthly statement received by the pool from its FCM could be successfully integrated into the recordkeeping requirements.

3. Self-dealing. Pool operators must be prohibited from engaging in transactions with the pools they operate.

DISCUSSION: For example, a dishonest pool operator could take advantage of the pool by engaging in a non-arms length sale of bullion to the pool at an inflated price. The pool operator should, however, be permitted to engage in non-arms-length transactions with the pool

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[24/] FCMs may invest customer funds only in United States obligations, general obligations of states or political subdivisions thereof and in obligations fully guaranteed as to principal and interest by the United States. CFTC rule 1.25.

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if he obtains the informed, prior consent of a majority of the pool participants.

4. Disclosure. Pool operators must be required to furnish prospective participants with complete information about the pool and the operator's qualifications.

DISCUSSION: The required items of disclosure should include, but not necessarily be limited to:

(a) The operator's background and experience in the operation of commodity pools and the management of commodity accounts, as well as his general business experience.

(b) A brief description of futures trading. As in the case of the risk disclosure statement,[25] the Committee urges the Commission to work with the industry in the development of a CFTC-approved, uniform description. Without CFTC approval, the descriptions contained in the pool operators disclosure documents will probably become lengthy, complicated, difficult to understand and, worst of all, unread.

(c) The identity of the firm(s) and/or individual(s) that will make trading decisions for the pool, including their qualifications (experience, education, etc.) and a general description of their trading strategies. The pool operator should not be required to reveal the precise fashion in which trading decisions will be made. Such information would be in the nature of a trade secret. The Committee does feel strongly, however, that the operator should provide some information as to what factors will be considered in the purchase and sale of futures contracts for the pool.

(d) The fees that will be paid by the pool for management and trading advice, including a complete description of the manner in which any incentive fee will be calculated.

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[25] See p. 9, *supra*.

(e) The affiliation, if any, between the pool operator and any FCMs with which the pool will maintain an account and any trading advisors it will retain; the degree to which brokerage commissions will be negotiated.

(f) The performance history (if any) of the pool. The pool's performance should be disclosed in a simple and understandable format, showing how a typical investment in the pool has fared. For example, in the case of a three-year old pool where the average investment was $10,000, there should be an explanation of how well $10,000 invested in 1973 has fared, how well a 1974 investment of $10,000 fared, etc.

Any description of performance should include a statement as to the average amount of funds in the pool during the period in question and the approximate percentage of those funds that were customarily committed to original margin. Without disclosure of these factors, a prospective participant cannot properly evaluate the pool or compare its performance to that of other pools. The amount of funds under management has a direct bearing on increase in net asset value (an important indicator of performance), as large percentage gains in net asset value are easier to achieve with a small pool of funds than a large pool. Disclosure of the amount of funds committed to margin is needed in order for the prospective participant to determine how highly leveraged — and thus how speculative — the pool is.

(g) The percentage of the pool's assets that will be committed as original margin for unhedged futures positions;[26/] the uses to

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26/ If the pool will be trading through an affiliated FCM, there should be disclosure of whether the pool will deposit funds or securities as margin and, if it deposits funds, whether the FCM will receive interest on those funds.

which funds not being committed to margin will be put, whether the pool operator, as distinguished from the pool, will receive any of the interest that is earned from funds of the pool.

(h) The redeemability and transferability of interests in the pool, and any costs associated therewith.

(i) whether the pool will: borrow funds; engage in cash commodity transactions; take or make delivery; trade commodity options; trade securities.

5. Reports to participants.

a. Periodic reports. Pool operators must be required to furnish each participant with a periodic report -- at least quarterly and perhaps monthly -- of the value of the participant's interest in the pool and the amount of management and advisory (including incentive) fees paid during the period. If the pool trades through an FCM that is an affiliate of the pool operator, the report should also disclose the brokerage commissions paid by the pool during the reporting period.

DISCUSSION: Pool operators should not be required to disclose the pool's open positions in the report, as knowledge of those positions — particularly if they are large — could perhaps be used for manipulative purposes.

If monthly reports are required, the Commission should nevertheless permit the operator to furnish a report on a quarterly basis if 2/3 of the pool's participants prefer quarterly reporting in the interest of reducing the pool's expenses.

b. Annual reports. Pool participants should be furnished an annual financial statement for the pool. The statement should be certified by an independent public accountant, except in the case of small, essentially local pools in which a 2/3 majority of the participants wish to dispense with the certified audit.

The expense of an audit does not seem justified when the pool is relatively small (in terms of assets and participants)[21] and the pool operator is an individual with whom the participants were acquainted before the pool was formed (for example, because he was their broker). If the Commission exempts such pools from the audit requirement recommended by the Committee, it should direct the operators of these pools to inform the participants of their right to waive the audit.

6. Reporting to CFTC. Pool operators should be required to report to the Commission any legal proceedings brought against them arising out of their business as pool operator, and such other information as the Commission deems appropriate.

7. Fitness standards. It is questionable whether pool operators should be required to take a commodity examination.

DISCUSSION: A pool operator's proficiency depends as much on his money management experience as it does on his knowledge of commodities and the futures markets. A pool operator who is also the trading advisor for the pool he operates should, however, be required to pass the commodity trading advisor examination if one is required.

8. Advertising.

a. Performance. In advertising the performance of any pool he operates, a pool operator must disclose fully and completely

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[21] It is difficult for the Committee to formulate standards in this area because of the lack of information concerning the size distribution of commodity pools.

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the pool's performance, including but not limited to its full operating history, the amount of funds that have been under management in the pool and the percentage of those funds that were customarily committed to original margin.

DISCUSSION: For example, if a two-year old pool performed well in 1975 but poorly in 1974 it should be unlawful for the pool's operator to advertise its 1975 performance without disclosing in the same advertisement the pool's 1974 performance.[28] Similarly, if a pool operator managed two pools, one of which performed considerably better than the other, the operator should be required to disclose the performance of the less successful pool in his advertising for additional participants in the successful pool.

Disclosure of the amount of funds under management and funds committed to original margin is necessary for the reasons discussed on p. 30, *supra*. To illustrate this point: if a pool operator advertises that his pool increased 50% in net asset value since it started, he should be required to disclose the average amount in the pool during the period. Similarly, in the situation of a pool operator who had formerly managed a very small pool and then began to promote a much larger pool, it would be misleading to the public if — in promoting the large pool — he advertised the fact that his former pool had gained 50% in net asset value and did not also reveal the small size of the pool.

b. Short-term performance. Pool operators should not be permitted to advertise performance that covers less than a one-year period.

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[28] By the same token, if a one-year old pool performed well in the most recent six months but poorly in the first six months, the operator should not be permitted to publicize only the recent period.

DISCUSSION: Although this prohibition may create some difficulties for new entrants into the commodity pool business, it is justified by the fact that short-term performance can be highly misleading.

c. Hypothetical portfolios. Pool operators must be prohibited from advertising the performance of hypothetical or simulated portfolios; performance advertising should be restricted to actual trades.

DISCUSSION: This prohibition also might make it difficult for newly-formed firms or young individuals to attract customers. This disadvantage is far outweighed, however, by the abuses that could easily flow from allowing such advertising. It is simply too easy to manufacture, after the fact, a highly successful, simulated portfolio.

9. Personal Trading.

a. Disclosure. The Commission should permit pool operators to comply with the trading-disclosure requirement of section 4n(4)(B) of the Act either by sending a quarterly trading and position report to the participants or by keeping a record, available for CFTC inspection, of their trades and positions.

DISCUSSION: The apparent purpose of section 4n(4)(B) — which states that pool operators must disclose to their participants the futures market positions taken or held by the "individual principals" of the pool operator organization —was to deter pool operators from "trading against"[29/] the pool. But it is questionable whether a disclosure procedure will serve that purpose well, and the procedure has several drawbacks.

[29/] For example, purchasing contracts just before placing a large order for the pool to purchase the same contracts.

The reasoning underlying section 4n(4)(B) was apparently that (1) the pool participants would be able to determine from the pool operator's trading reports whether the operator was taking advantage of the pool, and (2) the pool operator — knowing this — would refrain from unfair trading. However, because of the complexities of futures trading and the unsophisticated nature of many pool participants, it is questionable whether the participants would be able to determine whether the operator was taking advantage of the pool.

The Commission's staff, however, would be able to understand the trading reports. Thus, if the operator were required to maintain a record of his futures trading, which would be available for inspection at any time by the Commission, this should deter him from trading against the pool.

The other drawbacks to the disclosure system are (1) the pool participants might be inundated with information they are not interested in; (2) if the pool operator is a large trader, knowledge of his positions could possibly be used for manipulative purposes; (3) disclosure would probably be more costly than a record-keeping system; and (4) there might be situations in which an unsophisticated participant mistakenly concluded from the report that the operator was trading against the pool.

b. "Individual principals." This term should be construed to cover the pool operator itself and any general partner, officer or employee of the pool or the operator who participates directly in the selection of trades for the pool or obtains information about the pool's trades prior to their execution.

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10. Fees and expenses. As recommended above, pool operators should be required to disclose at the outset of the pool's operation the types and amounts of the fees and expenses they will charge the pool. The pool operator should be prohibited from causing the pool to pay fees or expenses in excess of those disclosed.

11. Performance fees. Pool operators should not be prohibited from charging appropriate performance fees (i.e., fees based upon the pool's trading profits), so long as the method of calculation is fully explained to participants prior to their entry into the pool.

DISCUSSION: It is generally unlawful for a security investment advisor to be compensated on the basis of the capital appreciation of the accounts he manages.[30] The apparent reason for this prohibition was a belief that incentive fees caused undue risk-taking by portfolio managers. But since risk-taking is an accepted element of commodities speculation, there is no basis for extending the prohibition to pool operators and trading advisors. In addition, there appears to be an affirmative need for incentive fees in commodities trading. Because large trades sometimes tend to move prices significantly, there is a practical limit to the size of commodity pools, and thus a limit to the amount a pool operator can charge by way of a net asset fee.[31] If it develops that pool operators are establishing unfair incentive fee arrangements, the Commission should regulate the types of incentive fees that may be charged.

30/ Investment Advisors Act of 1940, sec. 205 (15 U.S.C. 80b-5).

31/ Increasing the amount of the net asset fee would make it difficult to attract participants.

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12. Financial standards. Minimum financial requirements should be established for pool operators.

DISCUSSION: The operation of a commodity pool generally requires a significant expenditure of funds — for promotion, commodity research, accounting and legal fees, bookkeeping, computer time, etc. A pool operator that is under-capitalized, and thus unable to absorb these costs, may be tempted to convert assets of the pool. The establishment of a minimum financial requirement for the pool operator will help to prevent such misconduct.[32]

13. Suitability. The Commission should not prescribe minimum net worth or gross income requirements for pool participants.

DISCUSSION: The rationale for this recommendation is the same as that set forth in the discussion of why there should be no such requirements for FCM customers. Since there are different types of pools — just as there are different types of trading programs for FCM customers,— it should be the pool operator's responsibility to determine, with respect to each participant and pool, whether an investment in the pool in question is suitable.

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[32] The Commission should require only such personal financial information about the pool operator as is necessary and should strive to maintain the confidentiality of that information.

COMMODITY TRADING ADVISORS

A. Introduction

A commodity trading advisor is basically any person engaged in the business of issuing reports concerning commodities or rendering advice as to commodity futures.[33/] Explicitly excluded from the definition are: banks and trust companies; reporters; columnists and editors; lawyers; accountants; teachers; floor brokers; futures commission merchants; publishers of bona fide newspapers, news magazines, and business or financial publications of "general and regular circulation," including their employees; contract markets; and "such other persons not within the intent of . . . the trading advisor definition as the Commission may specify by rule, regulation or order."[34/] The exclusion is available to these persons only if the furnishing of the advisory services is

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[33/] The statutory definition of the term commodity trading advisor is contained in section 2(a)(1) of the Act:

> ". . . . The term 'commodity trading advisor' shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities. . . ."

[34/] Section 2(a)(1) of the Act. The Commisison has proposed a rule that, generally speaking, would exclude from the definition of trading advisor (i) trade associations, (ii) associated persons whose advisory activities are limited to the dispensing of house advice, and (iii) pool operators who advise only their pools. In proposing the rule, the Commission stated that, pending its decision on whether or not to adopt the rule, it would not require persons who qualified for the proposed exclusion to register. 40 F.R. 29090.

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"solely incidental to the conduct of their business or profession."[35/] A trading advisor generally must register with the Commission unless, during the preceding 12 months, he has not furnished comodity trading advice to more than 15 persons and has not held himself out to the public as a commodity trading advisor. Section 4m of the Act.[36/]

As of April 28, 1976, there were 436 trading advisors registered with the Commission.

B. Recommendations

1. Financial standards. The Committee does not recommend the establishment of minimum financial standards for trading advisors.

DISCUSSION: If, however, after studying this issue, the Commission finds that a need for financial standards does exist, the Committee believes they should be established. The appropriateness of minimum financial standards will depend upon the amount of funds that are typi-

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[35/] Section 2(a)(1) of the Act.

[36/] Advisors are subject to section 4n(4)(A) of the Act, which requires them to maintain such books and records and file such reports as the Commission prescribes, and to furnish to the Commission upon its request the name and address of each client and subscriber and samples of all literature distributed to those persons; section 4n(4)(B), which requires advisors to disclose to their clients and subscribers the futures market positions of the individual principals of the trading advisor organization; section 4o(1), which makes it unlawful for advisors to defraud or deceive existing or prospective clients; and section 4o(2), which prohibits advisors from stating or implying that registration with the CFTC represents approval of their abilities or qualifications. The Commission has not yet adopted substantive rules for trading advisors.

cally needed to establish and operate a viable organization. If it is found that the capital and income needs of operating a trading advisor organization are fairly high, then financial standards should be established in order to avoid situations in which the financial pressures of operating the organization result in misconduct.

2. Disclosure. Trading advisors should be required to disclose to prospective clients the risks of futures trading, the advisor's commodity experience and educational background, the general basis for the advisor' conclusions and recommendations, the affiliation or financial arrangements (if any) between the advisor and any future commission merchant whose services the advisor recommends, and such other information as the Commission deems necessary for prospective clients and subscribers to possess in order to make an informed decision as to whether or not to trade futures and use the advisor's services.

DISCUSSION: The advisor's disclosure of the risks of futures trading could probably be accomplished by means of the risk disclosure statement recommended for FCMs.

In recommending that the advisor disclose to prospective clients the basis for his recommendations, the Committee is not suggesting that the advisor be required to reveal matters that might be considered trade secrets. As discussed on page 16 with respect to pool operators, it would be sufficient if the advisor discloses the factors that he customarily relies upon in making recommendations — e.g., price trends and movements, cash prices, trading history, open interest, trading volume, crop reports and forecasts, production and consumption estimates etc. Unorthodox or unusual trading strategies should not be banned but rather disclosed.

3. Proficiency standards

a. Majority view: Advisors should be required to pass a basic commodities examination as a condition of registration.

DISCUSSION: First, while it may be more difficult to devise a trading advisor exam than an associated person exam, because of the diverse ways in which trading advisors function, the effort should be made. A trading advisor who lacks basic knowledge about the futures markets can cause harm to his clients and subscribers and a lessening of confidence in the futures industry; an examination requirement would help to increase the degree of professionalism in the industry.

Second, if APs are to be required to pass an exam, it is difficult to see how trading advisors should not. One of the reasons for testing APs is that they render trading advice, and trading advisors are generally less supervised than APs.

b. Minority view. An examination requirement for trading advisors would be inappropriate.

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DISCUSSION: Trading advisors are a relatively small class of registrants; it would be difficult to devise a meaningful examination for them because of the diverse ways in which they function; and the Commission would probably find it necessary to exempt a fair portion of the trading advisors from the examination requirement since a number of advisors apparently render advice solely about cash commodities and cannot be expected to understand commodity futures.

c. Advertising; passing of examination. The Committee was unanimous that trading advisors, and any other category of registrant, should be prohibited from advertising that they had passed a CFTC-prescribed exam. This type of advertising would imply that the CFTC had approved the registrant's abilities, and would thereby violate section 4o(2) of the Act.[37]

4. Advertising.

a. Performance. Trading advisors should be, at the very least, prohibited from disseminating information — by way of publications, broadcasts or seminars — about their own performance in the

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[37] That section provides:

> "It shall be unlawful for any commodity trading advisor or commodity pool operator registered under this Act to represent or imply in any manner whatsoever that he has been sponsored, recommended, or approved, or that his abilities or qualifications have in any respect been passed upon, by the United States or any agency or officer thereof: Provided, That this section shall not be construed to prohibit a statement that a person is registered under this Act as a commodity trading advisor or commodity pool operator, if such statement is true in fact and if the effect of such registration is not misrepresented."

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futures market (or how their recommendations or accounts they manage have fared) unless they disclose in the same advertisement the complete results of their trading (or all of their recommendations or accounts) for at least the past year. Any performance advertising that refers to percentage gains should also disclose the amount of money involved.

DISCUSSION: The Committee's rationale for this recommendation is the same as that set forth on page 34 with respect to pool operator advertising, namely, that the misleading nature of short-term results outweighs the hardships that would perhaps result from this prohibition. If a trading advisor does not have a one-year "track record" to disclose, he should not be prohibited from advertising his futures market performance.[38]

b. Hypothetical trades. Trading advisors, like pool operators and FCMs should be prohibited from publishing or broadcasting any advertisement or similar communication that refers to the performance of hypothetical or simulated trades, accounts or pools, or recommendations.

5. Scope of trading advisor definition. If a trading advisor handles clients' funds as part of its advisory business -- as distinguished from merely advising clients as to how their funds should be spent in the futures market -- it thereby becomes an FCM and should register, and be regulated, as an FCM.

DISCUSSION: The advisor who also handles clients' commodities funds falls squarely within the definition of an FCM and his clients are clearly in need of the protections afforded by the Commission's regulations for FCMs.

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[38] A number of the Committee members questioned whether the Commission should not simply ban performance advertising by advisors, on the ground that performance figures would be difficult to verify and easily susceptible to distortion and fabrication.

6. Personal trading. Trading advisors and their individual principals should be subject to the same requirements in this area as those recommended for pool operators on page 24, above. Any officer or partner of the trading advisor who participates in the making of the trading advisor's recommendations or who obtains information about those recommendations before their effective dissemination should be deemed a principal of the trading advisor for purposes of this requirement.

7. Recordkeeping. Trading advisors should be required to keep records of their personal futures trading (see p.34 above) and such other records as the Commission deems appropriate.

8. Reporting to Commission. Trading advisors should be required to file such reports with the Commission as the Commission deems appropriate.

9. Performance fees. Trading advisors should be permitted to charge clients a fee based upon the profits derived by the client from following the advisor's recommendations (See p. 36 supra.)

DISCUSSION: The rationale for this recommendation is basically the same as that set forth in the Committee's discussion of why pool operators should not be barred from charging performance fees.

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RECOMMENDATIONS OF GENERAL APPLICABILITY

1. Proficiency standards

a. Examinations. The central competency standard should be the successful completion of a commodities examination.

DISCUSSION: As stated above: (1) all new applicants for registration as associated person or commodity trading advisor should be required to pass the examination as a condition of registration; (2) the Commission should study the need for a pool operator examination; and (3) competency standards for floor brokers should be developed and enforced by the exchanges.

(1) The Commission should decide upon an appropriate organization to develop and operate the examination program.

DISCUSSION: Among the alternatives are: each exchange individually; a group of exchanges; a Title III organization; and the Commission itself. The Committee recommends that, in the interests of fostering self-regulation, the Commission not develop or operate the program but rather leave these tasks to the industry, subject of course to CFTC review and oversight. The Committee notes that the SEC has not found it advantageous to undertake handling the exam but has remained content to satisfy itself that industry efforts are evolving increasingly higher qualification standards.

(2) The organization that is to develop the examination should, in coordination with the Commission, prepare a task analysis of the job of each category of professional to be examined.

DISCUSSION: The development of task analyses, which are simply descriptions of what a person in a particular type of job must do and what he must know in order to do it, is probably the most important phase of the examination program. Only by reducing a job to specific tasks will the Commission be able to determine precisely what standards should be made applicable to each category of professionals.

Not only must each job be defined in terms of tasks performed, but also the level of attainment to be expected of each job category must be carefully spelled out. Consideration must be given to what will be required for an individual to progress from a lower level position to a higher, or from a firm which does one type business to a firm which does another type of business.

Once common elements and differing levels have been clearly revealed, the Commission, with the assistance of knowledgeable industry experts, will then be in a position to determine what standards are necessary for each type of professional.

If possible, there should be separate task analyses and examinations for identifiable subcategories of each profession. For example, it might be possible to distinguish between associated persons who are strictly supervisors and those who are strictly solicitors, or between associated persons who handle accounts and those who are merely order takers. Over-classification should of course be avoided, as it can cause severe and costly administrative problems.

(3) The Commission-industry group, with the aid of a testing consultant, should then prepare examination specifications, select question writers, and assemble the examination.

DISCUSSION: Upon completing a task analysis that specifies what a particular futures trading professional must do and know an objective (multiple choice) examination can be constructed which reflects that professional's job. The examination must:

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- be relevant and practical (which it will be when constructed from the task analysis);
- test concepts, application of knowledge and skills, and consequences of their application;
- be written in clear, concise language with clearly only one correct answer;
- be sound test-wise (i.e. meet recognized psychometric standards);
- be generic in industry-wide terms, not minutely specific;
- contain questions screened against the standards of "must the professional know this?" and if so "is it important enough to test?"; and
- test at entry level competence.

In addition

- A proliferation of examinations for every exchange and market should be avoided; and
- Principles and practices are more important than contract sizes on a specific exchange; the candidate must not be required to commit to memory for an examination things that in practice he will look up on a chart, etc.

(4) A recognized professional testing organization (e.g., Educational Testing Service) should be retained to administer the examination, under adequate security measures.

(5) Provisions should be made for maintaining the program (e.g., monitoring the continuing adequacy and relevancy of the questions) under the direction of a recognized professional testing organization.

b. Training. A properly-developed examination will in theory obviate the need for a training period requirement. Firms will find it necessary to train new employees adequately — or enroll them in adequate training programs — so that they can pass the examination. If the

Commission decides that a training requirement should be established, the program should be developed in basically the same manner as the examination.

DISCUSSION: The Committee recognizes that it may be too costly for small firms to establish adequate training programs. This problem can undoubtedly be overcome by encouraging commercial firms and industry associations to develop their own training programs, in which the smaller FCMs could enroll their employees at a reasonable cost. This pattern developed in the securities industry and there seems to be no reason why it would not occur in the commodities industry.

c. Education. Education requirements should not be established.

DISCUSSION: Job proficiency can be judged much more accurately through an examination program based on job analyses. To the extent that education may be relevant, this can be addressed by means of disclosure (e.g., of a trading advisor's educational background).

2. Advertising. In order to raise the advertising standards of commodity futures professionals and aid the media in determining what types of commodity advertising to accept, the Commission should publish advertising guidelines that describe in general terms examples of advertising practices that the Commission considers to be in violation of the antifraud provisions of the CE Act and the Commission's rules.

DISCUSSION: One of the Committee's major concerns [illegible] the advertising area was broadcast advertising by commodities firms and individuals, particularly on television. Because it reaches a vast audience, television advertising has a potentially enormous influence on the public. This, coupled with the public's general lack of understanding of the futures market and the references in advertising to the potential for

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large and rapid trading profits, creates a need for some type of control. The promulgation by the Commission of advertising standards would help broadcast stations to prevent improper advertising from reaching the public. The broadcasters are undoubtedly interested in the formation of advertising standards and would enforce them.

The Commission cannot possibly catalog every type of statement that is fraudulent, misleading or deceptive. And, the question of whether a particular advertisement violates the antifraud provisions usually cannot be decided in the abstract and will depend on the factual circumstances of each case. Nevertheless, it would be beneficial if the Commission were to provide some general indication of the kinds of advertising statements it will consider unlawful. The Committee suggests that the following principles, among others, be expressed in the guidelines:

(1) Statements that are technically accurate can be misleading if they omit facts necessary to convey the complete truth about a particular matter.

(2) References to the potential for large and rapid trading profits must be accompanied by an equally prominent statement to the effect that the same leverage which creates this potential also creates a potential for large losses

(3) Advertising of performance must present a complete picture of a professional's "track record" and not just a selective view of his successes. See, p. 30 supra. As discussed above, this means that performance figures must cover at least the past year's trading and all of the pools operated or accounts managed.

(4) Statements of opinion must be clearly labeled as such.

Ultimately, the formulation of advertising standards may perhaps be the function of a Title III association. However, if there are a significant number of firms that are not members of the association, only the Commission could develop an industry-wide standard.

Advertising standards should also apply to presentations at seminars, since that is often the means by which direct selling pressure is exerted upon the public.

The promulgation of advertising standards should be coordinated with the Commission's program of educating the public. A concerted program of education may well be the most effective means of providing the public with an understanding of the nature of, and risks inherent in, futures trading.

3. Registration fees. Registration fees should be based on the costs of processing applications and regulating the registrants.

4. Dual CFTC registration. Unnecessary dual registration should be avoided.

DISCUSSION: For example, if commodity trading advisors are subject to the same requirements as are associated persons, a registered advisor should not be required to register as an associated person.

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5. "Aggregation"[39] (While this subject was studied in depth by another advisory committee, the Committee did discuss the matter since it affects futures trading professionals.)

DISCUSSION: Accounts should be aggregated on the basis of whether the trading in those accounts is in fact under common control or is in fact being done pursuant to an express or implied agreement or understanding. The determinative test of control or agreement should not emphasize technical principal-agent or employer-employee relationships, although those relationships may have some bearing on whether control or agreement exists. For example, a situation of control in fact may exist in certain FCM guided account programs. That is, the positions of a participating customer should be aggregated with the FCM's positions if the customer normally trades in accordance with the FCM's recommendations, even though he may occasionally decline to follow the recommendations. On the other hand, FCMs should not be required to aggregate customer trading programs that are operated and managed completely independently of each other. The burden of proof should be upon the FCM to demonstrate such independence by program design, internal procedures and surveillance.

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[39] The term aggregation refers to the combining of trades and positions of two or more separate accounts for the purposes of determining compliance with the speculative trading and position limits established by the Commission (for example, 2,000,000 bushels in grain). The Commission is authorized to establish these limits by section 4a(1) of the Act, which also provides:

> ". . . . In determining whether any person has exceeded such limits, the positions held and trading done by any persons *directly or indirectly controlled by such person* shall be included with the positions held and trading done by such person; and further, such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons *acting pursuant to an expressed or implied agreement or understanding,* the same as if the positions were held by, or the trading were done by, a single person. . . ." (Emphasis added.)

The effect of this language is to require the aggregation of certain accounts for the purposes of speculative trading and position limits.

For example, if an FCM established three trading programs, each operating in a different part of the country, each managed by different employees of the FCM who did not confer with each other, and each program having different objectives, the programs should not be aggregated. Similarly, if a pool operator managed three commodity pools with totally different objectives and positions, those pools should not be aggregated.

The Committee recognizes the difficulty the Commission will face in making these determinations and the burdens that will be placed on the Commission's resources. Nevertheless, the Committee believes the burdens may be justified. Trading programs and commodity pools are evidently becoming increasingly attrative to the trading public and may serve a valuable economic function in bringing speculative funds into the market. Inflexible aggregation policies could retard the development of these programs and pools, to the detriment of the market.

In order to afford some guidance to the industry as to the types of situations in which the Commission will require aggregation, the CFTC should develop a written guideline describing the more commonly-recurring situations. If, in a particular case, a firm believed that aggregation was not appropriate, it would be required to demonstrate that there was in fact no control, understanding, or agreement in the case and also demonstrate internal policies to insure this.

6. Coordination with SEC and other agencies.

a. FCMs record-retention. The Commission should discuss with the SEC the possibility of establishing common record-retention periods for FCMs and securities broker-dealers.

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DISCUSSION: A considerable number of FCMs are also engaged in the securities business and thus are regulated by the SEC as broker-dealers. At present, the retention periods specified in the SEC's record-keeping rules are different in some cases from the periods specified in the CFTC's rules for the equivalent type of record. This creates a hardship for these dual registrants, as when it is time for destruction of one set of documents (for example, order tickets for securities) the FCM must separate out the other set (the order tickets for commodities). This seems to create a needless expense; to the extent feasible, it should be eliminated. The Committee is informed that a CFTC SEC Liaison Committee is studying this matter. The Committee encourages this effort.

b. Certified audits of dually-registered FCMs. As recommended above (p.5) the Commission should require FCMs to file certified financial statements with the Commission and should in that connection prescribe auditing standards. Since the FCMs that are registered with the SEC as broker-dealers must file certified financials with that agency in accordance with its audit standards, the two agencies should strive to make their requirements as consistent as possible in order to reduce auditing expenses. As recommended above (p.21), pool operators should be required to file certified financial statements for the pools they operate. Since a number of commodity pools are required by the SEC to file such statements, the Commission should explore the possibility of coordinating its requirements with the SEC's.

c. Disclosure by commodity pool operators. If the Commission requires pool operators to furnish information to prospective pool participants,[40/] the Commission should seek to coordinate that requirement with the SEC's prospectus-delivery provisions so that pool operators who register their pools with the SEC need not prepare two different disclosure documents.

[40/] See p. 29, *supra*.

MEMORANDUM OF LAW IN SUPPORT OF MOTION FOR TEMPORARY RESTRAINING ORDER

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS
CORP. and LLOYD, CARR & CO.,

Plaintiff,

- against -

WILLIAM T. BAGLEY, Chairman of the
COMMODITY FUTURES TRADING COMMISSION;
JOHN V. RAINBOLT III, Vice Chairman
of the COMMODITY FUTURES TRADING
COMMISSION; READ P. DUNN, GARY SEEVERS,
and ROBERT L. MARTIN, Commissioners
of the COMMODITY FUTURES TRADING
COMMISSION,

Defendants.

MEMORANDUM OF LAW IN
SUPPORT OF MOTION FOR
A TEMPORARY RESTRAINING
ORDER AND/OR PRELIMINARY INJUNCTION

76 Civ 5124
(Knapp)

PRELIMINARY STATEMENT

On November 16, 1976, the plaintiffs filed a Complaint seeking to temporarily and permanently restrain the defendants and their employees and/or agents from implementing or enforcing "proposed" regulations relating to commodity option transactions, substantially all of which automatically become effective on November 22, 1976, and related declaratory relief. The Court scheduled a hearing on plaintiff's motion for a preliminary injunction at 2:00 P.M. on November 19, 1976. On November 18, 1976 the Commodity Futures Trading Commission (the "Commission" or "CFTC") announced that they were postponing the effective dates of most of the provisions of the "proposed" rules until 15 days after republication of such rules in the Federal Register, with the segregation provisions to become effective 30 days after such re-publication. According to the Commission's minutes of November 18, 1976 as set forth in Release 223-76 these revisions are "technical changes to the regulations relating to commodity options transactions as previously published" by the Commission in the Federal Register on October 8, 1976, which are the subject matter of this litigation.

Included in such notice on October 8, 1976 was a provision inviting interested persons to submit to the CFTC prior to November 8, 1976 written comments on the proposed rules. In accordance with such notice, the plaintiff British American Commodity Options Corp. ("British American") filed written comments (Exhibit B to the Complaint, and Exhibit E to the Affidavit of John Forma sworn to on November 16, 1976). In addition, the undersigned has been advised that numerous other parties have furnished written comments to these regulations but because of the time schedule set up by the CFTC and their internal procedures, such written comments have not been disseminated to the general public or the affected business entities.

FACTS

As indicated by the comment letter submitted on behalf of British American, it is readily apparent that the "proposed" rules are blatantly anti-competitive and were designed for the specific purpose of arbitrarily and indiscriminately putting out of business all specialty London commodity option retail dealers without any due process and in the shortest time possible. In connection with the publication of these "proposed" rules in the Federal Register, the CFTC embarked on a massive public relations campaign indiscriminately describing all members of this industry as "crooks," "bunko artists," and "hotcheck artists." A representative sampling is annexed as an appendix to the Affidavit of James Carr sworn to on November 15, 1976. This industry consists of somewhere between 50 and 100 London commodity option dealers, whose customers range in number from 50 to over 5,000 customers per dealer. If the proposed rules, subject to the announced minor variations which do not substantively change the proposed rules or the legal issues raised by plaintiff, become effective in December 1976 there will be utter chaos in the market and in the industry.

Section 32.6 of the regulations as originally proposed would have mandated a negative cash flow of approximately 380% to each and every retail London commodity option dealer. The revision of this segregation provision mandated by the Commission's minutes of November 18, 1976 (copy attached) indicate a reduction in the segregation requirements from 100% to 90% which would reduce the negative cash flow to 342%. Under §32.6 there are only two alternatives available to retail London commodity option dealers: (1) immediately to cease operations, or (2) to defy the regulations and run the risk of severe civil and criminal penalties.1.) If the former, not only will there be havoc in the marketplace but their tens of thousands of customers will be required to pay commissions to the favored few to cover their options, for which the present members of this industry do not charge.

1.) 5 U.S.C. §13 (c)

The urgency of this situation is a direct result of the actions of the CFTC and not the plaintiffs. The written comment letter submitted on behalf of British American and certain other parties specifically requested public hearings and/or an administrative proceeding to consider these proposed rules. As to British American, this request was made in writing on November 5, 1976. At approximately 6:30 p.m. on November 11, 1976, the undersigned was notified by telephone, as a courtesy from the Office of General Counsel of the CFTC, that there would be no public hearings and that the CFTC intended to implement these rules without any delay. Accordingly, the undersigned immediately began the preparation of the necessary papers to file this suit and an Order to Show Cause seeking interim relief so that the rights of the plaintiffs and their many customers would be protected. On November 16, 1976, the staff of the CFTC advised the Court that the Commission may meet on Thursday, November 18, 1976 and might take such steps as to render this litigation moot. At 6:25 p.m. on November 16, 1976, Judge Whitman Knapp of the United States District for the Southern District of New York ordered a hearing with respect to plaintiffs' motion for a preliminary injunction pursuant to FRCP 65(a) at 2:00 p.m. on November 19, 1976.

In an attempt to moot this litigation the Commission met on November 18, 1976 and announced that it was postponing the effectiveness of these "proposed" rules until 15 days in the case of certain technical changes including the timing of the disclosure statement and 30 days in the case of the segregation requirements, after publication in the Federal Register.

From a practical standpoint the proposed changes in the segregation requirements are meaningless. Further the arbitrary and discriminatory disclosure statement will remain unchanged. These requirements show a complete lack of knowledge of London commodity options and the mechanics of the operations of the plaintiffs herein.

ARGUMENT

I. A FEDERAL DISTRICT COURT HAS JURISDICTION TO ENJOIN A FEDERAL REGULATORY AGENCY FROM IMPLEMENTING AND/OR ENFORCING REGULATIONS PROMULGATED BY SUCH AGENCY AND IN CONNECTION THEREWITH TO GRANT DECLARATORY RELIEF.

Based upon the conversation between the undersigned and the Office of General Counsel on November 11, 1976, the CFTC is apparently taking the position that the federal courts have no jurisdiction because the discretion vested in that agency by the Commodity Exchange Act of 1974, as amended (the "Act"), is so broad that the "proposed" rules are within the limited class of actions committed to agency discretion by law under 5 U.S.C. §701(a)(2). However, this position is contrary to the other provisions of the Administrative Procedures Act (5 U.S.C. §§701 through 706) and the decisional law. 5 U.S.C. §702 provides as follows:

> "A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof."

As to pre-enforcement review of these "proposed" regulations the plaintiffs and other companies similarly situated are such persons entitled to judicial review. Abbott Laboratories v. Gardner, 387 U.S. 136, 87 S.Ct. 1507, 18 L.Ed.2D 681 (1967); Dunlop v. Bachowski 421 U.S. 560, 95S.Ct. 1851, 44 L. Ed.2d 377 (1975); City of Rye, New York v. Schuyler, 355 F.Supp. 17 (S.D.N.Y. 1973). Neither the Act nor the underlying legislative history indicates any Congressional intent to restrict judicial review of the CFTC's actions.

The scope of judicial review is set forth in 5 U.S.C. §706, which provides as follows:

> "To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall--
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> (1) compel agency action unlawfully withheld or unreasonably delayed; and
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> (2) hold unlawful and set aside agency action, findings, and conclusions found to be--
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> (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
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> (B) contrary to constitutional right, power, privilege, or immunity;
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> (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory rights;

> (D) without observance of procedure required by law;
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> (E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or
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> (F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.
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> In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error." (emphasis added)

The leading case setting forth the standards of judicial review of agency action is Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 91 S.Ct. 814, 28 L.Ed.2D 136 (1971), wherein it was held that 5 U.S.C. §701(a)(2) was only applicable where there is "no law to apply." Clearly, there is "law to apply" in this situation and thus the exemption for action "committed to agency discretion by law" contained in 5 U.S.C. §701(a)(2) is inapplicable to the instant case.

The decisional law in the lower courts subsequent to Citizens to Preserve Overton Park, Inc. v. Volpe (supra), is uniformly in accord. Sabin v. Butz, 515 F.2d 1061 (9th Cir. 1971), cert. denied sub. nom., Kaibab Industries, Inc. v. Parker, 405 U.S. 989, 92 S.Ct. 1255, 31 L.Ed.2d 455; National Resources Defense Council, Inc. v. Securities and Exchange Commission, 389 F.Supp. 689 (D.C. 1974). Of course, it has always been the law that judicial review is proper where an agency promulgates rules of general application affecting substantial rights. See, e.g., Columbia Broadcasting Systems Inc. v. United States, 316 U.S. 407, 62 S.Ct. 1194, 86 L.Ed.2d 1563 (1942) and United States v. Storer Broadcasting Co., 351 U.S. 192, 76 S.Ct. 763, 100 L.Ed. 1081 (1956).

As pointed out in Citizens to Preserve Overton Park, Inc. v. Volpe (supra), the existence of judicial review is only the starting point.

II. SINCE THE RE-PUBLICATION OF THE PROPOSED REGULATIONS DO NOT MOOT PLAINTIFFS' CONTENTIONS THE PROCEEDING SHOULD NOT BE STAYED

The definitive and controlling Supreme Court criteria for ripeness for pre-enforcement judicial review of administrative rules and regulations are set forth in what is referred to as the Abbott Laboratories trilogy. Abbott Laboratories v. Gardner (supra); Toilet Goods Association v. Gardner 387 U.S. 158, 87 S.Ct. 1520, 18 L.Ed.2d (1967) and Gardner v. Toilet Goods Association 387 U.S. 167, 87 S.Ct. 1526, 18 L.Ed.2d 704 (1967). Also see Dunlop v. Bachowski (supra) wherein the Abbott Laboratories trilogy was recently reaffirmed by the Supreme Court.

Under the Abbott Laboratories trilogy there are two tests to determine whether or not a matter is ripe for judicial review: (i) fitness of the issues for review and (ii) hardship to the plaintiffs if the Court refuses to hear the case.

The Supreme Court has now made the law of ripeness a matter of common sense. Continental Air Lines, Inc. v. CAB 522 F2d

107 (D.C. Cir. 1975); A.O. Smith Corp. v. F.T.C. 530 F2d 515 (3rd Cir. 1976). The implementation of these "proposed" rules would immediately put the plaintiffs out of business and, thus, monetary damages would be inadequate. This constitutes irreparable harm. Danielson v. Local 275, Laborers Union 479 F2d 1033 (2nd Cir. 1973). For an excellent analysis of irreparable harm compare A.O. Smith Corp. v. F.T.C. 396 F. Supp. 1108 (D.C. Del. 1975) rev'd on this issue A.O. Smith Corp. v. F.T.C. (supra). Similarly, the plaintiffs' contentions remain the same even after the Commission's action of November 18, 1976.

The Commission's attempt to abort this litigation is ineffectual. Their minutes and press release clearly state that the first segment of the "proposed" rules will become effective 14 days after publication. Under 5 U.S.C. §553(d) 30 days notice is required unless the agency comes within the limited exceptions that these actions are (i) minor or (ii) an emergency measure. Texaco, Inc. v. Federal Power Commission 412 F2d 740 (3rd Cir. 1969). If these revisions to the "proposed" rules are deemed substantive or major then the re-publication of these rules would be a nullity. Kelly v. United States Department of Interior 339 F. Supp. 1095 (E.D. Cal. 1972); Texaco, Inc. v. Federal Power Commission (supra). In short, under their announced timetable the defendants are precluded from taking the position that this litigation is mooted by the actions to be taken as a result of these November 18, 1976.

In view of the importance of the issues raised by the plaintiffs, the fact that they are already before the Court and that the first segment will become effective on approximately December 13, 1976 it would be appropriate and just for the Court to make a decision, with the appropriate findings of fact and conclusions of law, sufficiently prior to December 13, 1976 so that the party that does not prevail, especially if it is the plaintiffs, will not be effectively deprived of its right to appeal an adverse determination. The "ripeness" test under the Abbott Laboratories trilogy should be given a broad and flexible reading _Gordon & Co._ v. _Board of Governors_ of _Federal Reserve System_ 317. F. Supp. 1045 (D.C. Mass. 1045). This is especially true when the plaintiffs are _parens patriae_ to their customers. _State of Florida_ v. _Weinberger_ 492 F2d 488 (5th Cir. 1974)

The defendant's chicanery to again force the plaintiffs and the Court to eleventh hour brinksmanship should not be tolerated. The very livelihood of 50 businesses and thousands of employees, as well as severe financial repercussions to its tens of thousands of customers is an important matter which deserves far better treatment. The next step is what are the proper standards of review under 5 U.S.C. §706 and whether the defendants have violated any of such standards.

III. THE "PROPOSED" RULES RELATING TO COMMODITY OPTION TRANSACTIONS VIOLATE EACH OF THE STANDARDS SET FORTH IN 5 U.S.C. §§706 (2)(A), (B), (C), (D), AND (F).

A. The Proposed Rules are Arbitrary, Capricious, and Abuse of Discretion, or Otherwise Not in Accordance with Law.

An analysis of certain of the provisions of the "proposed" regulations contained in the comment letter of British American heretofore filed describes in detail how certain of the provisions of these "proposed" regulations on their face are arbitrary, capricious, unreasonable and an abuse of the CFTC's rule-making powers. In addition, there may be other examples cited by other persons who furnished comments. Due to the procedure and timetable adopted by the CFTC, these comments have not been made available to the general public or the parties directly affected by such rules within a sufficient period of time to enable plaintiffs to apprise the Court of the possibility of other violations of 5 U.S.C. §706.

A typical example is the registration provision which now requires all commodity options dealers to register as futures commission merchants ("FCM").2.) However, Regulation 1.19, now in effect, states that an FCM is prohibited from dealing in London commodity options. The plaintiffs herein and numerous other companies similarly situated are exclusively engaged in the purchase and sale for customers of London commodity options. In this connection, it should be noted that the CFTC's preliminary comments to these rules, as set forth in Exhibit A to the Complaint,

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2.) Prior hereto the CFTC had an informal policy requiring such dealers to register as commodity trading advisors.

specifically state that the Commission is not repealing Reg. 1.19. However, the CFTC may in its discretion grant an exemption to Reg. 1.19 to individual parties. No standards are set forth in the proposed regulations or preliminary comments or anywhere else as to what the criteria will be for such exemptions which will be arbitrarily granted to the favorite few. In view of the recent case entitled Commodity Futures Trading Commission v. British American Commodity Options Corp. (S.D.N.Y. 76 Civ. 3247)(reported in CCH Fed. Comm. Fut. L. Rep. ¶20,224), wherein the Commission's motion for a preliminary injunction was denied by way of a directed verdict, it is clear that as to British American, the staff will not permit it to operate by way of an exemption under Reg. 1.19. Query, what due process does that company have if the staff arbitrarily and capriciously denies it an exemption?

The Commission's justification for this proposal, as well as certain others, is that all of the persons now engaged in this industry are "crooks," "bunko artists," and "hot-check artists." The plaintiffs should be judged individually. Punitive regulations as to an entire industry should not be adopted without a careful review by the federal court. The decisions in the two litigated cases instituted by the CFTC against London commodity options dealers are directly contrary to the CFTC propaganda. Propaganda is no substitute for facts. Reference is made to the British American case (supra) and CFTC v. J.S. Love & Associates Options Ltd., CCH Fed. Comm. Fut. L. Rep. ¶20,198 (S.D.N.Y. 197[illegible].

Another example is the proposed segregation requirements, which are set forth in the British American comment letter, requiring that in December 1976, each and every retail commodity options dealer will be required to set aside approximately $3.50 for each $1.00 in gross revenues. It is obviously impossible to operate any business under these circumstances. The 10% reduction to be effected by the re-publication is meaningless. The violation of the standards set forth in 5 U.S.C. §706(2) is aggravated since there is absolutely no factual basis for the CFTC's assertion that double or triple segregation is required for customer protection.

Segregation is not required for the type of business conducted by plaintiffs. Segregation as to the plaintiffs is clearly a punitive measure without any factual, economic or legal justification, which is also in contravention of 5 U.S.C. §706(2)(F). The most basic inquiry would show that plaintiffs' method of operations is identical to securities broker-dealers who clear through other firms and do not hold customers' funds. Accordingly, as to ethical and honest dealers who do not deal in naked options, segregation is inapplicable. Ironically, as presently drafted, dishonest persons who sell naked options, (i.e. who do not subsequently purchase the options on the ICCH or LME) would be exempted from registration as an FCM. As to them, segregation would be proper.

Under the Securities Exchange Act of 1934, as amended, the net capital requirements are far less than $50,000.

Appropriate safeguards for the investing public are set forth in the comments furnished on behalf of British American on March 10, 1976 and November 5, 1976. These are far more stringent than analogous requirements applicable to securities broker-dealers who operate in an identical manner.

It is well established that there must be some rational relationship between the alleged public interest and the burden on private interests. Federal Trade Commission v. Baltimore Grain Co. 284 F. 886 (D.C. Md. 1922 aff'd per curiam 267 U.S. 586, 45 S. Ct. 461, 19 L.Ed. 800 (1923). Such is not the case with these proposed regulations. Reference is made to the discussion of the fact that neither the ICCH nor LME has ever defaulted on a commodity option or the recent events in this industry set forth on pages 4 and 8 of the British American comment letter. As a result of these "proposed" rules, the investing public will have to pay unnecessary fees which will be a windfall to the five or six major securities dealers waiting on the sidelines. The defendants have deliberately ignored the rights of the investing public and the plaintiffs herein for reasons known only to themselves. Such a rip-off should not be legalized.

Another example is the disclosure requirements which not only illustrate a complete lack of understanding as to the basic nature of this business but impose upon London commodity option dealers the most arbitrary, capricious and punitive disclosure requirements ever seen with respect to any form of investment. In contrast, purveyors of commodity futures contracts on margin, a far more risky investment, who are also regulated by the CFTC, are not required to make any similar disclosures.3.) Nor are such disclosures required for similar forms of investment such as securities, real estate, coins, stamps, municipal bonds, etc. In this connection it should be pointed out that the general anti-fraud provisions under the

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3.) Their net capital requirement is only $10,000.

Commodity Exchange Act of 1974, as amended, (the "Act"), are even broader than the anti-fraud provisions under the federal securities laws. See CFTC v. J.S. Love & Associates Options, Ltd. (supra). If, in fact, there are abuses in the industry, the CFTC has more than sufficient ammunition and capabilities to take the appropriate action against the party or parties who are engaged in such course of conduct. Rather than performing its duly authorized regulatory function in a proper manner, the CFTC is attempting by fiat in these disclosure requirements to abdicate its responsibilities by arbitrarily placing upon all retail dealers of London commodity options such unique and onerous disclosure requirements that it will be impossible for them to operate.

The requirement that such disclosures must be made at least 24 hours prior to the execution of any order for a customer is clearly impracticable in view of the fast moving nature of the commodity markets both in this country and London. As a practical matter, the timing of this disclosure is an impossibility. A securities broker-dealer could not make this type of disclosure before executing an order. Accordingly, it is my understanding that the Commission now intends to abandon the 24 hour requirement in the re-publication of the "proposed" rules. But they deliberately intend to keep the onerous and discriminatory disclosure requirements.

B. The Proposed Regulations are Contrary to Constitutional Right, Power, Privilege or Immunity.

This is so obvious that it does not merit substantial discussion. The practical effect of these regulations is to put substantially all of the existing retail London commodity option dealers summarily out of business without any hearing or opportunity to be heard. Due process of law is being emasculated. Not only has the CFTC refused to hold any public hearings or administrative proceeding with respect to these regulations, which are clearly a punitive measure, whose sole purpose is the elimination of an entire existing industry, the Commissioners have attempted to rush these through in the minimal amount of time and have utilized various devices to attempt to lull both the industry and the courts into a state of inaction prior to November 16, 1976.

As early as March 8, 1976, the plaintiff offered to provide its expertise to the CFTC to assist it in formulating suitable regulations (See Exhibit "B" to the Affidavit of John Forma). Defendant's about face from its July, 1976 proposals relating to commodity options transactions is not explained. The cavalier attitude of the Commissioners and the staff is strikingly evident by their continued refusal to hold a hearing relating to the abolition of all existing retail London commodity options dealers, including the plaintiffs' herein.

The rights of these business entities to remain in business and their individual employees and customers should not be at the mercy of the whims of certain individuals. See Berends v. Butz 357 F. Supp. 143 (D.C. Minn. 1973). To make matters worse their attempts to justify their unilateral denial of rights guaranteed by the Fifth and Fourteenth Amendments by a smear campaign in the media offends all traditional notions of fair play. The people have a right to expect better treatment from their government.

The CFTC's argument that existing retail London commodity dealers have no right to remain in business was summarily rejected by Judge Warren Burger, who is now Chief Justice of the United States Supreme Court, in Gonzalez v. Freedman 334 F.2d 570 (D.C. Cir. 1964):

> "Thus, to say that there is no "right" to government contracts does not resolve the question of justiciability. Of course there is no such right; but that cannot mean that the government can act arbitrarily, either substantively or procedurally, against a person, or that such person is not entitled to challenge the processes and the evidence before he is officially declared ineligible for government contracts.
>
> An allegation of facts which reveal an absence of legal authority or basic fairness in the method of imposing debarment presents a justiciable controversy in our view." at page 575.

In the instant case the plaintiffs' position is even stronger as the CFTC permitted them to build up a successful business. See CFTC v. British American Commodity Options Corp. (supra).

C. The Proposed Rules are in Excess of Statutory Jurisdiction, Authority, or Limitations, or Short of Statutory Right and Were Issued Without Observance of Procedure Required By Law.

Section 19 of the Act specifically provides that:

> "The Commission shall take into consideration the public interests to be protected by the anti-trust laws and endeavor to take the least anti-competitive means of achieving the objectives of this chapter . . . in issuing any order or adopting any Commission rule or regulation . . ."

Under the Act, the CFTC is affirmatively required to take the least anti-competitive means in promulgating regulations. The Commission has done exactly the opposite. If these regulations are enacted and implemented in their present form, the Commission will have created an oligopoly consisting of five major securities broker-dealers who have either acted as wholesalers for the existing retail London commodity options dealers or who have blissfully waited on the sidelines pending the implementation of these rules. They will then march in and pick up all of the customers of the existing retail commodity option dealers at no cost while the industry that has been eliminated has spent many millions of dollars to create these customers when no one else would risk their capital in embarking in a new area of investments. Accordingly, as a matter of law, such regulations should be declared unlawful and set aside. Pillai v. CAB, 485 F.2d 1018 (D.C. Cir. 1973); Overseas Media Corp. v. McNamara, 385 F.2d 308 (D.C. Cir. 1967) and Hecht v. Pro-Football, Inc., 444 F.2d 931 (D.C. Cir. 1971), cert. denied, 404 U.S. 1047, 92 S.Ct. 701, 30 L.Ed. 2d 736.

The reason this is being done now is that solely because of the efforts of the plaintiffs herein and certain other companies similarly situated, London commodity options have become a viable and popular investment vehicle in this country. Prior to these companies entering this area, this form of investment was almost unheard of in the United States and because of the Goldstein-Samuels situation, which was the principal basis for revising the old Commodity Exchange Act, the general public was extremely leery of purchasing London commodity options. Now that a few brave persons have legitimatized and popularized London commodity options it is unconscionable arbitrarily and capriciously to deprive them of reaping their just rewards.

The anti-trust provisions of the Act were not inserted by accident. When the statute was originally proposed and drafted by the House, it contained a provision which merely required the Commission to take into consideration the public interest to be protected by the anti-trust laws. The Department of Justice objected to this language and as a result of their efforts the House version of the Act was amended to also require the CFTC to endeavor to take the least anti-competitive means. 1974 U.S. Code Cong. Adm. News, pages 5847 and 5863.

The Office of General Counsel of the CFTC and the staff have indicated to the undersigned that it is their position that under the Act, the CFTC has the power to abolish all trading in London commodity options. This is an error in at least two respects. In the first place this statute has now been on the books for 2-1/2 years and during this period the Commission has permitted persons to engage in this business. Now that certain companies, such as the plaintiffs herein, at a cost and expense of millions of dollars have created a viable investment vehicle in the United States with tens of thousands of customers, it would be grossly inequitable now to put these people out of business by administrative fiat so that the business can be taken over by a favored few large securities broker-dealers who were unwilling to risk their investment capital when there was a substantial risk involved. As Judge Gagliardi pointed out in Commodity Futures Trading Commission

v. British American Commodity Options Corp. (supra), at footnote 12 at page 21,215, this is inequitable. Secondly, although the Act retained the prior prohibitions against existing domestic options, it did permit trading in options in all other commodities if not done contrary to any rule, regulation or order of the Commission prohibiting any such transactions or allowing any such transactions under such terms or conditions as the Commission may prescribe; provided, however, that "[T]he Commission could promulgate such an order, rule or regulation only after notice and opportunity for hearing." 1974 U.S. Cong. Adm. News at page 5850. Accordingly, the procedure utilized by the CFTC also violates 5 U.S.C. §706(a)(D) and (E). The purpose of 5 U.S.C. §553 was to allow the general public to participate in the rulemaking process in a meaningful way and to enable the agency properly to educate themselves before establishing rules which have a substantial impact on those to be regulated. Texaco, Inc. v. Federal Power Commission (supra) Also see NLRB v. Wyman-Gordon Co. 394 U.S. 759, 89 S.Ct. 1426, 22 L.Ed. 2d 709 (1969). Accordingly, as a practical matter, the defendants have violated 5 U.S.C. 706(2)(D).

In short, the Commission is attempting to do indirectly what it could not do directly. If they issued a rule which unilaterally prohibited trading in London commodity options after this 2-1/2 year wait and in view of the events that occurred during that period, it is obvious that a federal court would not hesitate to strike down such rules. Thus, in an attempt to circumvent this, they have "proposed" rules which would have the same practical effect except that it would create an oligopoly for a few selected large securities broker-dealers. It is only when it became self-evident that the investing public had made a decision that this was a good investment and money was being taken away from the stock market and futures commodity contracts on margin for London commodity options that such companies as E.F. Hutton announced that they were entering the business and supported the "proposed" regulations. Now these few brokerage houses will be in a position arbitrarily to fix prices in direct contravention of 7 U.S.C. §19.

WHEREFORE, the undersigned, on behalf of the plaintiffs, respectfully requests that the Court preliminarily enjoin the defendants from implementing or enforcing the "proposed" regulations relating to commodity options and for such other and further relief as the Court deems just and proper under the circumstances.

Dated: New York, New York
November 22, 1976

Charles J. Hecht, Esq.
Attorney for Plaintiffs
60 East 42nd Street-Suite 1760
New York, New York 10017
(212) 490-3232

Haig Costikyan, Esq.
Of Counsel

EXHIBIT TO MEMORANDUM OF LAW

Official Minutes - CFTC

Thursday, November 18, 1976 10:15 a.m.

Commissioners: William Bagley, John Rainbolt, Read Dunn, Robert Martin

Staff: Tony McDonald, Howard Schneider, Pam Pecarich, Bill Schief, Norm Ross, Susan Starling, Joe Burns, Neal Stults, Greg Walker, DeVan Shumway, Nate Most, Fred Santo, Jim Stiner, Fred Spindel, Terry Claassen, Charlie Robinson, Don Weiss, Fred White, Jerry Markham, Ed Nowicki, Jane Stuckey

Subject: OPEN — Commodity Option Rules

Actions: The Commission formally considered (a) public comments received with respect to its proposed interim rules for regulating commodity options, which comments had previously been distributed to the members of the Commission for their evaluation, and (b) suggested changes to those rules recommended by its staff as a result of an evaluation of the comments received. Upon due consideration, the Commission determined that

(1) the staff should make, and was directed to make, certain technical, clarifying and substantive revisions to the rules including, but not limited to, a revision to §32.6 which will require segregation of 90% of the purchase price, as defined;

(2) the staff should promptly submit the rules, as appropriately revised, to the Commission for final adoption pursuant to the Commission's authority under Sections 2a(1), 4c(a), 4c(b) and 8a(5) of the Commodity Exchange Act;

(3) upon adoption, the rules, as revised, will become effective 15 days after publication in the Federal Register, except the segregation provisions contained in §32.6 thereof, which will become effective 30 days after publication in the Federal Register; provided, however, that the effective date of the futures commission merchant and associated person registration provisions of the rules shall, as earlier proposed, be January 17, 1977; and

(4) as a result the commodity option rules in the form published on October 8, 1976, 41 Fed. Reg. 44560, _et seq._, will not become effective on November 22, 1976, as previously announced.

EXHIBIT TO MEMORANDUM OF LAW

Wall Street Journal
November 19 1976 page 40 - col 4

Commodity Agency Adopts Regulations For London Options

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON—The Commodity Futures Trading Commission adopted rules to regulate so-called London commodities options trading in this country.

The commission also decided that the rules would take effect in stages in December and January, rather than next Monday, as indicated earlier.

Except for some technical changes, the rules are generally the same as previously proposed. They cover off-exchange options sold to the U.S. public. Those are London options offered through dealing members of London commodity exchanges.

Under the rules, London options trading would be regulated in a manner similar to other commodities trading. Last September the commission voted against banning London options trading in the U.S. The agency has brought several cases against U.S. concerns that have defrauded customers in sales of the options.

Among the adopted rules are requirements that persons and firms dealing in options register with the commission, that a disclosure be made to customers of fees and markups and that customer funds be protected by being kept in accounts separate from a commodity firm's other funds.

The commission made various technical changes in the rules after meeting with representatives of the London markets.

The commission separately is considering rules to allow and govern commodity-options trading on regulated commodity futures exchanges in the U.S. for a three-year test period. The agency's staff is drawing up rules. The test, as previously reported, would be to determine the impact of commodity-options trading on the markets and to assess the capability of exchanges to assure orderly business and conduct surveillance of trading. Several exchanges have indicated an interest in starting commodity-options markets.

EXHIBIT TO MEMORANDUM OF LAW

[¶ 3430] Reg. § 32.1. Definitions.

Reproduced below are the texts of Regs. § 32.1—32.10, as proposed by the CFTC, October 8, 1976 (¶ 20,217).

As used in this Part—

(a) "Commodity option transaction" and "commodity option" each means any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty" involving any commodity regulated under the Act other than wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice;

(b) "Interstate commerce" shall be construed and have the same meaning as set forth in sections 2(a) and 2(b) of the Act;

(c) "Option customer" means any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option, but shall not include a person required to register as a futures commission merchant in accordance with this Part;

(d) "Purchase price" means the total actual cost paid or to be paid, directly or indirectly, by an option customer for entering into and maintaining an interest in a commodity option transaction by whatever name called; and

(e) "Striking price" means the price at which an option customer may purchase or sell the commodity or the contract of sale of a commodity for future delivery which is the subject of a commodity option transaction.

[¶ 3431] Reg. § 32.2. Prohibited Transactions.

No person may offer to enter into, enter into, confirm the execution of, or maintain a position in, any transaction in interstate commerce involving—

(a) wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice, or

(b) any contract of sale of any commodity for future delivery traded on or subject to the rules of any contract market or involving the prices of such contracts, except under such terms and conditions as the Commission shall prescribe;

if the transaction is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

[¶ 3432] Reg. § 32.3. Unlawful Commodity Option Transactions.

(a) On and after January 17, 1977, it shall be unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as a futures commission merchant under the Act and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked.

(b) On and after January 17, 1977, it shall be unlawful for—

(1) any person to solicit or accept orders (other than in a clerical capacity) for the purchase or sale of any commodity option, or to supervise any person or persons so engaged, unless such person is

(i) registered as a futures commission merchant under the Act, or

(ii) if such person is an individual, registered as an associated person of a specified futures commission merchant under the Act;

and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) any futures commission merchant to permit an individual to become or remain associated with such futures commission merchant as a partner, officer or employee (or in any similar status or position involving similar functions) in any capacity involving such solicitation, acceptance or supervision if such futures commission merchant knew or should have known that such individual was not registered as an associated person or that such registration has expired, been suspended (and the period of suspension has not expired) or revoked;

(c) A person required to register as a futures commission merchant or as an associated person in accordance with this Part which furnishes the services specified in that portion of Section 2(a)(1) of the Act defining the term "commodity trading advisor" shall not be included in the term commodity trading advisor if:

(1) At the time such services are furnished, such person is registered as a futures commission merchant or as an associated person under the Act, and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) The furnishing of such services is solely incidental to the conduct of such person's activities requiring such registration.

(d) A person registered as a futures commission merchant or an associated person under the Act, who is required to register as such by virtue of this Part, need not re-register as such but shall immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under this Part.

[¶ 3433] Reg. § 32.4. Exemptions.

(a) Except for the provisions of sections 32.2 and 32.9, which shall in any event apply to all commodity option transactions, the provisions of this Part shall not apply to a commodity option offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or

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merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.

(b) The Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of this Part, other than sections 32.2, 32.8 and 32.9, if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption.

[¶ 3434] Reg. § 32.5. Disclosure.

(a) Prior to the entry into any commodity option transaction, each prospective option customer shall be furnished with a summary disclosure statement by the person soliciting the order therefor not less than 24 hours prior to the entry into the commodity option transaction. Except as provided in paragraph (b) of this section, the disclosure statement shall contain the following:

(1) The actual amount of the purchase price and the elements comprising the purchase price, including a separate listing of the premium, markups on the premium, costs, fees and other charges, as well as the method by which the premium is established.

(2) A statement of:

(i) the services to be provided for the separate elements comprising the purchase price,

(ii) the striking price, and the method by which the striking price is established,

(iii) the total quantity and quality of the commodity which may be purchased or sold upon exercise of the commodity option or which underlies the contract of sale for future delivery which may be purchased or sold upon exercise of the commodity option, and

(iv) any and all additional costs which may be incurred by the option customer if the option is exercised, including, but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise) and all similar fees and charges;

(3) The price level which the underlying commodity or the underlying contract of sale for future delivery must reach during the life of the option in order that the option customer realize a profit in the commodity option transaction, together with a clear explanation of the effect of any foreign currency fluctuations if the option is to be executed on or through the facilities of a foreign board of trade;

(4) The following boldface statement on the first page of the disclosure statement:

BECAUSE OF THE VOLATILE NATURE OF THE COMMODITIES MARKETS, THE PURCHASE OF COMMODITY OPTIONS ARE NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC. A PERSON SHOULD NOT PURCHASE A COMMODITY OPTION UNLESS HE IS PREPARED TO SUSTAIN A TOTAL LOSS OF THE PURCHASE PRICE OF THE COMMODITY OPTION. SUCH TRANSACTIONS SHOULD BE ENTERED INTO ONLY BY PERSONS WHO ARE AWARE OF THE POTENTIAL FOR LOSS AND WHO UNDERSTAND THE NATURE AND EXTENT OF THEIR RIGHTS AND OBLIGATIONS. THESE COMMODITY OPTIONS HAVE NOT BEEN

APPROVED OR DISAPPROVED BY THE COMMODITY FUTURES TRADING COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS STATEMENT. ANY REPRESENTATION TO THE CONTRARY IS A VIOLATION OF THE COMMODITY EXCHANGE ACT AND THE REGULATIONS; THEREUNDER; and

(5) Statements to the effect that:

(i) specific market movements of the commodity or contract of sale of a commodity for future delivery underlying the option cannot be accurately predicted, and

(ii) generally, an option customer will be unable to sell his option in any market to recover any of the purchase price, but rather may only liquidate by exercising the option before the expiration date of the option or by entering into an offsetting transaction.

(b) To the extent that any of the actual price information required to be disclosed by the relevant portions of paragraphs (a) (1), (2) and (3) of this section is not known at the time the disclosure statement is to be delivered to the option customer, the person required to deliver the disclosure statement shall deliver as part of the disclosure statement, at the time specified, all the other information required by paragraph (a) of this section, as well as a good faith estimate of such price information, and shall provide all actual price information in writing to the option customer immediately upon the execution of the commodity option transaction for the option customer.

[¶ 3435] Reg. § 32.6. Segregation.

(a) Any person which accepts money, securities or property from an option customer as payment of the purchase price in connection with a commodity option transaction shall treat and deal with such money, securities and property as belonging to such option customer until expiration of the term of the option or, if the option customer exercises the option, until all rights of the option customer under the commodity option have been fulfilled. Such money, securities and property (1) shall be separately accounted for and segregated as belonging to such option customer, (2) shall be kept in the United States, and (3) shall not be commingled with the money, securities or property of any other person, including the money, securities or property received by a futures commission merchant to margin, guarantee or secure the trades or contracts of commodity customers (as defined in § 1.3(k) of this chapter) or with the money accruing to such commodity customers as the result of such trades or contracts: *provided, however,* that the money, securities or property treated as belonging to an option customer may for convenience be commingled with the money, securities or property treated as belonging to any other option customer and deposited in the same account or accounts with any bank or trust company in the United States. Such money, securities and property, when so deposited with any bank or trust company, shall be deposited under an account name which will clearly show that it contains money, securities or property, segregated as required by this Part. Each person depositing such money, securities or property shall obtain and retain in its files for the period provided in § 1.31 of this chapter an acknowledgment from such bank or trust company that it was informed that the money, securities and property therein are being treated as belonging to option customers and are being held in

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accordance with the provisions of this Part. Such bank or trust company shall allow inspection of such accounts at any reasonable time by representatives of the Commission.

(b) No money, securities or property deposited in accordance with paragraph (a) of this section shall be held, disposed of, used or treated as belonging to the depositing person or any person other than the option customers of such person: *provided, however,* that such money may be invested in obligations of the United States, and in obligations fully guaranteed as to principal and interest by the United States. Such investments shall be made through an account or accounts used for the deposit of money, securities or property received from option customers and proceeds from any sale of such obligations shall be redeposited in such account or accounts. Each person which invests money belonging to option customers in obligations as described in this paragraph (b), shall separately account for such obligations and segregate such obligations as belonging to such option customers. Such obligations may only be deposited with a bank or trust company in the United States and shall be deposited under an account name which will clearly show that it contains obligations treated as belonging to option customers, segregated as required by this Part. Each person depositing such obligations shall obtain and retain in its files an acknowledgment from such bank or trust company that it was informed that the obligations are treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such acknowledgment shall be retained for the period provided in § 1.31 of this chapter. Such bank or trust company shall allow inspection of the obligations at any reasonable time by representatives of the Commission.

(c) Each person which invests money treated as belonging to option customers as permitted hereunder shall keep a record showing the following: (1) the date on which such investments were made, (2) the name of the person through which such investments were made, (3) the amount of money so invested, (4) a description of the obligations in which such investments were made, (5) the identity of the depositories or other places where such obligations are segregated, (6) the date on which such investments were liquidated or otherwise disposed of and the amount of money received on such disposition, if any, and (7) the name of the person to or through which such investments were disposed of.

(d) Persons which invest money in obligations described in paragraph (b) of this section shall include such obligations in segregated accounts at values which at no time shall be greater than current market value, determined as of the close of the market on the last preceding market day.

(e) The deposit and/or investment of money as provided in paragraphs (a) or (b) of this section shall not operate to prevent the person so depositing and/or investing such money from receiving and retaining as its own any increment or interest resulting therefrom.

(f) The amount of money, securities and property which is and which must be in a segregated account in order to comply with the requirements of this Part shall be computed by each person required to segregate such money, securities and property as of the close of each business day. A record of such computation shall be made and kept, together with all supporting data in accordance with the provisions of § 1.31 of this chapter. Such computation shall be made prior to the opening of business on the next business day.

[¶ 3436] Reg. § 32.7. Books and Record Keeping.

(a) Each person which accepts any money, securities or property (or extends credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to such transactions. Such records shall at least include all orders (filled, unfilled or cancelled), signature cards, books of record, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements required by § 32.5 of this Part, solicitation or advertising material, circulars, memoranda, publications, writings, and all other literature or written advice distributed to option customers or prospective option customers. Upon the request of an authorized representative of the Commission, such person shall furnish the true name and address of each commodity option customer or prospective commodity option customer solicited.

(b) Each person referred to in paragraph (a) of this section shall also keep a record in permanent form which shall show the true name and address of each maker, underwriter, issuer or other person who assumes or purports to assume any financial responsibility for the fulfillment of any commodity option transaction solicited or accepted by such person.

(c) Each person which accepts an order for a commodity option transaction from a person other than an option customer, shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to the transaction. Such records shall at least include the items set forth in paragraph (b) of this section and, to the extent necessary to reflect such person's participation in the transaction, shall include all items set forth in paragraph (a) of this section.

(d) Each person which accepts an order for a commodity option shall immediately upon receipt thereof prepare a written record of such order, including an account identification and order number, and shall record thereon by time-stamp or other device, the date and time, to the nearest minute, that (1) the order is accepted, (2) the order is transmitted for execution, and (3) the order is executed. Each such person which accepts any money, securities, or property (or extends credit in lieu thereof) from an option customer as payment of the purchase price in connection with the commodity option transaction shall, upon confirmation that the order was executed, notify the option customer of the date that the order was executed.

(e) All records, memoranda and other documents required to be maintained by paragraphs (a) through (c), and to be prepared by paragraph (d), of this section shall be retained for the period specified in § 1.31 of this chapter, and each person required to maintain such records shall be required to produce the same for inspection and furnish true and correct copies thereof and information and reports as to the contents or meaning thereof, when and as requested by any authorized representative of the Commission or the United States Department of Justice.

[¶ 3437] Reg. § 32.8. Unlawful Representations.

It shall be unlawful for any person required to be registered with the Commission in accordance with this Part expressly or impliedly to represent that the Commission, by declaring effective the registration of such person

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or otherwise, has directly or indirectly approved such person, or any commodity option transaction solicited or accepted by such person.

[¶ 3438] Reg. § 32.9. Fraud in Connection with Commodity Option Transactions.

It shall be unlawful for any person directly or indirectly—

(a) to cheat or defraud or attempt to cheat or defraud any other person;

(b) to make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

(c) to deceive or attempt to deceive any other person by any means whatsoever;

in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction.

[¶ 3439] Reg. § 32.10. Option Transactions Entered into Prior to the Effective Date of this Part.

Nothing contained in this Part shall be construed to apply to any commodity option transaction lawfully entered into prior to the effective date of this Part.

[The next page is 3393.]

AMENDED COMPLAINT

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP., and LLOYD, CARR & CO., Plaintiffs,	:	76 Civ. 5124 (Knapp)
- against -	:	AMENDED COMPLAINT FOR A PRELIMINARY AND PERMANENT INJUNCTION
WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT, III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS, and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION, Defendants.	:	

Come now the plaintiffs, by their attorney, CHARLES J. HECHT, and for their first cause of action against the defendants allege as follows:

1. The individual defendants herein at all times since January 1st, 1976, have been the Commissioners of the Commodity Futures Trading Commission.

2. Plaintiff BRITISH AMERICAN COMMODITY OPTIONS CORP. ("BRITISH AMERICAN") is a corporation with its principal offices located at 80 Wall Street, New York, New York, which is exclusively engaged in the retail sale and purchase of commodity options through the International Commodities Clearing House, Ltd. (the "ICCH"), and the London Metals Exchange (the "LME").

3. Plaintiff LLOYD, CARR & CO. ("LLOYD, CARR") is a sole proprietorship with its principal offices located at 84 State Street, Boston, Massachusetts, which is exclusively engaged in the retail sale and purchase of commodity options through the ICCH and the LME.

4. Jurisdiction is conferred upon this Court by reason of 5 U.S.C. §706, 7 U.S.C. §3, 28 U.S.C. §1331, and 28 U.S.C. §1337.

5. This proceeding is brought to temporarily restrain and to enjoin the defendants and their agents and employees from implementing and/or enforcing regulations relating to commodity option transactions published in the Federal Register on November 24th, 1976, and a declaratory judgment as to the legality and constitutionality of a substantial portion of such regulations. A copy of the regulations, as published in the Federal Register on November 24th, 1976, annexed hereto as Exhibit "A", and hereinafter referred to as the "regulations".

6. Exclusive of Sections 32.3 and 32.6, all of such regulations will become automatically effective within 15 days of publication (December 9th, 1976) and the notification in the Federal Register specifically excludes any public comments with respect to the final adoption of such regulations.

7. The regulations are null and void because they were not published in accordance with 5 U.S.C. §553(b)(B) and 5 U.S.C.

§553(d), in that, amongst other things, (i) the defendants have deprived the plaintiffs and other interested persons from submitting comments on these regulations, and (ii) that the rules, as published, fail to comply with the requirement that an agency seeking to invoke the "good cause" exception must set forth therein a specific finding and a statement of the reasons therefor why 30 days' notice is impracticable, unnecessary or contrary to the public interest.

8. That the minimum financial requirements established by these regulations for London commodity option dealers first detailed on November 24th, 1976, and which now incorporate therein by reference Regulation 1.17 presently in effect as to purveyors of futures contracts, which is annexed hereto as Exhibit "B", violate various provisions of 5 U.S.C. §706 in that, amongst other things, such regulations are:

(a) arbitrary, capricious, an abuse of discretion, and punitive, in violation of Section 2(A) thereof, in that they -

(i) require BRITISH AMERICAN and LLOYD, CARR, respectively, to raise capital of $3,000,000 and $1,000,000 by December 9th, 1976, because such dealers will be required to have minimum net capital of $50,000 plus 5% of aggregate indebtedness, which includes equity in customers' accounts, plus the safety factors set forth in Regulation 1.17;

(ii) place the dealer in a conflict of interest position to its customers because the more equity in the customers' accounts, the more severe the financial requirements of the dealer;

(iii) have no relationship to the method of operations of the plaintiffs and other retail dealers of London commodity options or protection of customers of such dealers;

(iv) are inconsistent with the segregation requirements of Section 32.6 and impose substantial additional financial requirements over and above said segregation requirements (Reference is made to Exhibit "C", annexed hereto which is a table showing such computations, as to British American); and

(v) are, in effect, only applicable to plaintiffs and other dealers similarly situated because existing purveyors of futures contracts as members of domestic exchanges (where commodity options are now prohibited) or registered with the Securities & Exchange Commission are exempted;

(b) contrary to Section 2(B) thereof, since this is insufficient time for plaintiffs to raise such capital in order to remain in business and are depriving plaintiffs, their employees and their customers as to whom they are parens parentae without due process of law, as guaranteed by the Fifth and Fourteenth Amendments, since the defendants are not authorized to unilaterally put the plaintiffs out of business through the imposition of net capital rules which make it an impossibility for any retail London commodity option dealer to operate;

(c) in excess of statutory jurisdiction, authority or limitations, or short of statutory right, in that such requirements, as recognized by the defendants, are anti-competitive in direct violation of 7 U.S.C. §19;

(d) contrary to Section 2(D) thereof, as set forth in Paragraphs 6 and 7 hereof; and

(e) contrary to Section 2(F) thereof, in that such minimum capital requirements are clearly unwarranted in fact or in law.

9. As a result, the minimum financial requirements established will cause immediate and irreparable harm to the plaintiffs, as well as their employees and customers, as it will require them to raise substantial additional capital within the next 12 days, which is not a realistic possibility, especially in view of the other aspects of a regulatory scheme established by the defendants.

10. That the disclosure requirements (i.e. information to be furnished to actual or potential customers) set forth in Section 32.5 of the regulations and related provisions violate various provisions of 5 U.S.C. §706, in that, amongst other things, such regulations are:

(a) arbitrary, capricious, an abuse of discretion, and punitive in violation of Section 2(A) thereof, because:

(i) the plaintiffs are required to disclose the option writer's premium, their mark-up, and the strike price, prior to (contrary to the releases issued by the defendants after November 18th, 1976, and the representations of their counsel in court on November 23rd, 1976) execution of the customer's order and such information is only available after the customer's order is executed and confirmed through the ICCH or LME and, thus, as to each and every summary disclosure statement issued by plaintiffs, the plaintiffs will be subject to severe civil and criminal penalties for violation of the anti-fraud provisions of Section 32.9, and reparations proceedings under 7 U.S.C. §17(b) as to their customers, since the premium price to be charged by the writer of the option on the ICCH and LME is established after the order is executed and confirmed and, thus, the mark-up, premium, and strike price will be different from that set forth in the disclosure statement since the plaintiffs guarantee the total cost to the customer and bear the risk of loss for an increase in the premium, as well as the strike price which is only ascertained after the execution and confirmation of the order on the Exchange;

(ii) certain of the disclosures requested will, by nature, be false and misleading and/or totally irrelevant; e.g. the effect of fluctuations in the currency valuations, since the customers only bear any such risk or reward between the times of execution of the close-out of their transaction and the receipt of their funds (which is a matter of days) and there is no accurate way to forecast such item or its effect on the value of an option over the term of the option, and the only method of closing out options is to buy or sell, as the case may be, a futures contract on the ICCH or LME and, thus, the required disclosure statement is false and misleading; and

(iii) such disclosures are not required by purveyors of futures contracts or any other commodity;

(b) contrary to Section 2(B) thereof, because the plaintiffs are being deprived of their property without due process of law, in violation of the Fifth and Fourteenth Amendments;

(c) contrary to Section 2(C) thereof, since:

(i) such disclosures are recognized by defendants to be in direct violation of 7 U.S.C. §19, which requires the defendants in promulgating any rule or regulation to adopt the least anti-competitive means; and

(ii) there is no authority in Section 4(c)(b) of the Commodity Exchange Act for such requirements;

(d) adopted without observance of procedure required by law in violation of Section 2(D) thereof, all as set forth in Paragraphs 6 and 7 hereof;

(e) contrary to Section 2(F), because such requirements are clearly not warranted by the facts.

11. As a result, the requirements set forth in Section 32.5 of the regulations and related provisions unfairly discriminate against and prejudice plaintiffs - to their immediate and irreparable harm.

12. That the segregation requirements set forth in Section 32.6 of the regulations and related provisions violate various provisions of 5 U.S.C. §706, in that, amongst other things, such regulations are:

(a) arbitrary, capricious, an abuse of discretion, and punitive,in violation of Section 2(A) thereof because:

(i) they mandate a negative cash flow in that they require approximately $3.50 of cash outlay for each $1.00 in gross revenues to the plaintiffs and other dealers similarly situated, thus requiring the operation of an economically unfeasible business (all as more fully set forth in Exhibit "D", annexed hereto);

(ii) they have absolutely no relationship to the proper protection of customers;

(iii) when read in conjunction with the minimum financial requirements constitute additional punitive measures; and

(iv) the exemption provisions of Section 32.4 grant the staff of the CFTC arbitrary powers without establishing any standards for granting and/or denying the exemption;

(b) contrary to Section 2(B) thereof, in that:

(i) they deprive plaintiffs of their property without due process in violation of the Fifth and Fourteenth Amendments;

(ii) as recognized by the defendants, in violation of 7 U.S.C. §19, which requires the defendants in promulgating rules and regulations to utilize the least anti-competitive means; and

(iii) the exemption provisions of Section 32.4 grant the staff arbitrary powers without establishing any standards for granting and/or denying the exemption;

(c) contrary to Section 2(C) thereof, in that such regulations, as conceded by the defendants, are anti-competitive in direct violation of 7 U.S.C. §19 which requires the defendants in promulgating rules and regulations to utilize the least anti-competitive means;

(d) contrary to Section 7(F) because such requirements are clearly not warranted by the facts.

13. Accordingly, the segregation requirements set forth in Section 32.6 of the regulations will cause immediate and irreparable harm to the plaintiffs, their employees, and their existing customers, who may be required to pay substantial fees and commissions for closing out their options through other entities, as a result of these regulations, which will immediately force the plaintiffs out of business.

14. That certain aspects of the book and record keeping requirements as set forth in Section 32.7 of the regulations

violate various provisions of 5 U.S.C. §706 in that, amongst other things, such regulations are:

(a) arbitrary, capricious, an abuse of discretion, and punitive in violation of Section 2(A) thereof, because:

(i) they fail to define the term "solicited";

(ii) they establish an unreasonable burden on plaintiffs to upon request"furnish the true name and address of each commodity option customer or prospective commodity option customer solicited" when, in fact, the plaintiffs have no way to verify such information (e.g. reference is made to the transcript of the hearing in the case entitled CFTC vs. BRITISH AMERICAN COMMODITY OPTIONS CORP. (76 Civ. 3247 S.D.N.Y.) at Tr. pages 33, 34, 35, 42, 43, 45, demonstrating the use by agents of the defendants of assumed names and false addresses in their contacts with the plaintiff BRITISH AMERICAN); and

(iii) they impose an unduly burdensome obligation on plaintiffs which has no reasonable relationship to a proper regulatory scheme;

(b) contrary to Section 2(D) thereof, as set forth in Paragraphs 6 and 7 hereof.

15. That the registration requirements set forth in Section 32.3 of the regulations entitled "Unlawful Commodity Options Transactions", which relate to the requirement that the plaintiffs, as well as all other London commodity option dealers, must register as futures commission merchants ("FCM") violates various provisions of 5 U.S.C. §706 in that, amongst other things,

such regulations are:

(a) arbitrary, capricious, an abuse of discretion, and not in accordance with law because:

(i) they require plaintiffs to register as an FCM whilst Reg. 1.19 specifically prohibits an FCM from transacting commodity options; and

(ii) the exemption provisions of Section 32.4 fail to establish any standards for the granting and/or denying of an exemption under Section 32.3;

(b) in violation of Section 2(B) thereof because they deprive plaintiffs of their property without due process, in contravention of the Fifth and Fourteenth Amendments, in that the exemptive provisions of Section 32.4 fail to establish any standards for the granting or denying of an exemption under Section 32.3;

(c) in violation of Section 2(D), since they were adopted without observance of procedure required by law, all as more fully set forth in Paragraphs 6 and 7 hereof; and

(d) as they are unwarranted by the facts, in violation of Section 2(F) thereof, in that the method of operations of the plaintiffs is entirely different from the method of operations of purveyors of futures contracts.

16. Accordingly, pursuant to the allegations in Paragraph 15 hereof, the plaintiffs and their employees are subject to immediate and irreparable harm because they can arbitrarily be denied registration as an FCM, without any due process, and denies the plaintiffs equal protection of the law.

17. That the regulations, as an integral scheme of regulation, promulgated on November 24th, 1976, by the defendants, establishes an improper, intolerable, punitive, and unworkable regulatory framework as to the plaintiffs and other dealers similarly situated and fail to satisfy the statutory mandate imposed on the defendants, as well as the constitutional requirements of the Constitution and statutes of the United States.

WHEREFORE, the plaintiffs request the following relief from the Court:

(a) declaring that the regulations relating to commodity option transactions are being implemented without observance of the procedural requirements of the Administrative Procedures Act;

(b) declaring that the regulations relating to commodity option transactions are in violation of 5 U.S.C. §706(2) et seq.;

(c) that the Court issue a preliminary injunction preventing and restraining the defendants, their agents, officers, attorneys, employees, successors, and assigns, and all persons in concert with them from implementing or enforcing the regulations relating to commodity option transactions published in the Federal Register on November 24th, 1976, during the pendency of this action;

(d) that this Court issue a permanent injunction preventing and restraining the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing the regulations relating to commodity option transactions published in th the Federal Register on November 24th, 1976; and

(e) that the plaintiffs be given all such other, further, and different relief as this Court may deem just and proper.

Dated: New York, New York,
November 26th, 1976.

Charles J. Hecht
CHARLES J. HECHT
Attorney for Plaintiffs
60 East 42nd Street - Suite 1760
New York, New York, 10017
Tel: (212) 490-3232

Of Counsel:

HAIG COSTIKYAN
MARTIN H. KAPLAN
GUSRAE, GREENE & KAPLAN
67 Wall Street
New York, New York, 10005

EXHIBIT "A" TO AMENDED COMPLAINT

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

Chapter 1--Commodity Futures Trading Commission
Part 1--General Regulations Under the Commodity Exchange Act
Part 30--Fraud in Connection With Commodity Transactions
Part 32--Regulation of Commodity Option Transactions

Adoption of Rules

The Commodity Futures Trading Commission ("Commission") has adopted interim regulations under the Commodity Exchange Act, as amended, 7 U.S.C. 1 et seq. (Supp. V, 1975), relating to commodity options substantially in the form previously announced with certain technical and substantive revisions deemed necessary as a result of comments received. On October 8, 1976, the Commission published a proposal to adopt interim regulations as the first step in a two-stage procedure under which the Commission plans to adopt comprehensive regulations for a limited, rigidly-controlled, three-year (or shorter) test program that ultimately will require commodity options to be purchased and sold on or through the facilities of Commission-designated boards of trade in the United States or Commission-recognized foreign options systems. See 41 Fed. Reg. 44560 (October 8, 1976). Except to the extent discussed below, the Commission's discussion of the basis and purpose of rules proposed at that time constitutes the basis and purpose of the interim rules adopted today. A copy of the Commission's announcement of October 8, 1976, is published as an appendix to this Federal Register Notice.

The Commission's October 8, 1976 Federal Register Notice contained a review of the Commission's consideration of the issues surrounding the regulation of commodity options in this country, including a summary of the Commission's prior regulatory proposals; set forth a discussion of the basis and purpose of the Commission's two-stage regulatory proposal, including a section-by-section analysis of the Commission's proposed interim rules; and invited interested persons to participate in the rule-making process by providing written submissions to the Commission. The Commission has considered all of the comments and suggestions received and has determined to adopt the interim rules in the form set forth below. Such rules, as adopted, shall become effective 15 days after publication of this notice in the Federal Register (December __, 1976), except that the segregation provisions contained in section 32.6 of the rules w[illegible]me effective 30 days after such publication (December __, 1976).

At the outset, the Commission wishes to emphasize certain aspects concerning the interim rules adopted today. The authority granted to the Commission by the Congress to regulate commodity option transactions is extremely broad. Under Section 2(a)(1) of the Act, 7 U.S.C. 2 (Supp. V, 1975), the Commission has "exclusive jurisdiction" with respect to "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery . . . ." Section 4c(a)(B) of the Act prohibits the offer and sale of certain commodity options--generally those relating to agricultural commodities which were regulated under the Commodity Exchange Act prior to the 1974 amendments thereto. For a list of those commodities see section 2(a)(1) of the Act and section 32.2(a) of the regulations adopted today. Under Section 4c(b) of the Act, it is unlawful to offer or sell an option involving any other commodity regulated under the Act contrary to such rules and regulations as the Commission may prescribe.[1/] In

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[1/] Section 4c(b) governs options involving the newly-regulated commodities (i.e., those coming under regulation after the 1974

(footnote continued)

pertinent part, that Section provides as follows:

> No person shall offer to enter into, enter into, or confirm the execution of, any [commodity option] transaction . . . contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. . . . 2/

Accordingly, the Commission is empowered under Section 4c(b) to determine if and under what circumstances commodity option trading will be permitted. Under this authority the Commission could prohibit all commodity option trading, permit all commodity option trading under such terms and conditions as it shall prescribe, or permit some forms of trading, subject to the Commission's rules and regulations, and prohibit others.

The rules announced today reflect the Commission's considered judgment as to the appropriate method of regulating commodity option transactions in this country. The Commission's determination has been made after extensive Commission study of the offer and sale of commodity options in the United States, a process which has consumed substantial Commission resources and has involved the solicitation of the broadest possible public participation. Just four days after the effective date of the Commodity Futures Trading Commission Act of 1974, which established the Commission, the Commission solicited written comments with respect to

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1/ (footnote continued)

amendments to the Commodity Exchange Act), namely "all other goods and articles [except onions] * * * and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in * * *." Section 2(a)(1) of the Act.

2/ In addition, the Commission has general rule-making authority under Section 8a(5) of the Act, 7 U.S.C. 12a(5) (Supp. V, 1975).

its proposed antifraud rule relating to commodity options. 40 Fed. Reg. 18187 (April 25, 1975). On June 24, 1975, the Commission adopted a broad antifraud rule applicable to commodity option transactions. 40 Fed. Reg. 26505 (June 24, 1975). On October 22, 1975, the Commission announced that it was considering the adoption of rules to regulate--or perhaps forbid--transactions in commodity options, including the promulgation of a temporary rule pending the adoption of a definitive regulatory program. 40 Fed. Reg. 49360 (October 22, 1975). On February 20, 1976, the Commission proposed comprehensive regulations governing off-exchange commodity option transactions. 41 Fed. Reg. 7774 (February 20, 1976). At the time of that proposal, the Commission stated that it was affirmatively considering restricting commodity option transactions solely to organized exchanges and the Commission invited public comment on whether the Commission's regulatory program should include the segregation of premiums received by option dealers and the delivery of a disclosure statement to prospective purchasers. The Commission received written comments following the publication of its proposal, and the Commission held oral hearings in Washington, D.C., on March 8, 1976, during and subsequent to which it received additional comments on the issues raised by its announcement.

During this period, the Commission's Advisory Committee on the Definition and Regulation of Market Instruments was also considering regulatory recommendations relating to commodity options. That Committee was requested to submit a report and recommendations to the Commission on appropriate regulations or restrictions concerning commodity options. See 40 Fed. Reg. 32866 (August 5, 1975). The Advisory Committee's report was transmitted to the Commission on July 6, 1976 and was published as a special supplement, numbered 26, to the CCH Commodity Futures Law Reporter (July 15, 1976) and was also made available by the Commission to all interested persons.

After carefully considering the comments received on its prior proposals, the presentations made at its oral hearing in March 1976, the report and recommendations of its Advisory Committee, and the comments received on its proposal of October 8, 1976, the Commission has determined to adopt the interim rules announced today pursuant to the broad authority contained in Sections 2(a)(1), 4c(a), 4c(b) and 8a(5) of the Act. The Commission believes that affected persons and members of the public have had ample opportunity to comment on the Commission's proposed regulatory program; the Commission has evaluated all of the comments received; and the Commission has determined that the public interest requires that it adopt rules regulating the offer and sale of the commodity options without further delay.

Many of the persons who commented on the Commission's proposal of October 8, 1976, maintained that the Commission's proposal was anti-competitive in various respects: that it imposed stricter standards on persons dealing in commodity options than are presently imposed on persons dealing in commodity futures contracts; that it discriminated unfairly between futures commission merchants dealing in commodity options and futures commission merchants dealing in commodity futures contracts; and that it required disclosures to prospective option customers that are not required to be made to prospective customers dealing in commodity futures contracts. In proposing and in adopting the interim rules, the Commission has taken into account its responsibilities under Section 15 of the Act, 7 U.S.C. 19 (Supp. V, 1975), and has determined that the options regulations in the form proposed and as adopted meet the requirements of that Section. Section 15 requires that the Commission take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives, policies and purposes of the Act. While the Commission is mindful that the financial, segregation and other criteria imposed as prerequisites to allowing a person to enter into or continue in the commodity options business may result in some lessening of competition, in its judgment, the interim rules are necessary to effectuate an essential purpose and policy of the Act: That is to require that the Commission provide essential customer protections which would attempt to assure the financial solvency of option transactions and prevent fraud. As a result, rules have been adopted, particularly in the areas of registration, disclosure, segregation and minimum working capital, which are intended to provide such customer protections as are deemed essential. Such rules may have an anticompetitive effect in that not all persons will be able to comply because of lack of adequate financing or other reasons. Nonetheless, in weighing its responsibilities, the Commission has determined that the objectives, policies and purposes of the Act can be met, in its judgment, only by regulations such as these.

In this connection the Commission wishes to emphasize that, since its inception in April 1975, a very substantial part of its resources devoted to the enforcement of the Act and the regulations thereunder have been directed to monitoring the activities of commodity options dealers, to investigating those activities, and to bringing resulting enforcement actions. The Commission believes that its experience of the past 18 months bears out the Congressional judgment that strong regulatory safeguards are needed in connection with the commodity options business [see, e.g., H.R. Rep. No. 93-975, 93d Cong., 2d Sess., 37 (1974)]. The Commission's experience in the field of futures contracts has been salutary in comparison to the options area. As a result, the Commission has provided for greater financial responsibility and increased disclosure requirements for option dealers than for those dealing with futures contracts.

The Commission does not understand Section 15 of the Act to require that the Commission permit entry into or maintenance of the commodity options business at the expense of the public interest considerations with which the Act is concerned. On the contrary, the Commission views Section 15 as a Congressional judgment that the public interest protected by the antitrust laws be considered in the context of the Commission's judgment of how best to effectuate the policies and purposes of the Act, including the Commission's express authority to regulate--or to forbid--commodity option transactions. Thus, the essential judgments made have been made in light of Section 15 of the Act.

The Commission also wishes to stress that as proposed and as adopted, section 32.3 of the interim rules provides that on and after January 17, 1977, it will be unlawful for a person to solicit or accept orders for commodity options transactions or for an individual to be associated with any such person, unless registered as a futures commission merchant or as an associated person of such futures commission merchant, respectively, under the Act. Therefore, the Commission again wishes to advise affected persons to file their applications for registration promptly. The Commission is already processing applications for registration which it has received as a result of its announcement of the proposed interim rules. A person who defers filing an application runs the risk that the application may not be processed before the January 17th deadline. Normal requirements for processing are 30-60 days. While the Commission intends to expedite the processing of applications, a prompt filing will enable the Commission to do so on a timely basis.

Finally, the Commission stated in its October 8, 1976 announcement that the proposed interim rules would become effective on November 22, 1976. In order to alleviate some of the concerns expressed by the commentators that it would be difficult to comply with certain aspects of the proposed interim rules by that date, the Commission has determined to adopt the interim rules effective 15 days after the date of the publication of this notice, and, with respect to the segregation requirements contained in Section 32.6, 30 days after the date of such publication. However, as indicated above, the Commission has determined to retain the

January 17, 1977 date in the registration provisions of the interim rules.

Set forth below is a synopsis of the interim rules in the form adopted, together with the discussion of certain general and specific comments received by the Commission and of the revisions made in the proposed interim rule as a result of those comments and further consideration by the Commission.

DEFINITIONS

One commentator suggested that the definition of "option customer" in §32.1(c) should be amended to include a person who writes or grants an option through a futures commission merchant, since such a person is a customer of the futures commission merchant. The Commission has determined not to amend the definition at this time because it believes for purposes of its interim rules that coverage of option customers by virtue of the definition is sufficiently broad to encompass the vast majority of persons who are affected by such transactions. However, the Commission is considering appropriate amendments to the option customer definition in connection with the second stage of its regulations to be announced shortly. It was also suggested that the definition of "purchase price" in §32.1(d) was too broad and should be broken down into its essential components such as the premium, sales commissions and other fees. In light of the Commission's treatment of segregated funds, discussed below, where such definition has particular importance, the Commission does not believe that an amendment to this definition is desirable.

PROHIBITED TRANSACTIONS

One commentator suggested that §32.2(b) should be amended to make clear that that section prohibits only the offer or sale of commodity options involving domestically traded futures contracts and prices of such contracts, and not commodity option transactions relating to futures contracts traded on foreign boards of trade. The Commission believes that §32.2(b) is sufficiently clear on this point and does not purport to prohibit commodity option transactions involving futures contracts traded on foreign boards of trade. Of course, such transactions are prohibited if the contracts involve those commodities which were regulated prior to the 1974 amendments to the Act and which are the subject of Section 4c(a)(B) of the Act, as incorporated in §32.2(a) of the interim rule.

UNLAWFUL COMMODITY OPTION TRANSACTIONS

As proposed and as adopted, §32.3 specifies the circumstances under which persons accepting funds or other property from option customers as payment of the purchase price of the commodity option or soliciting or accepting orders for commodity options are required to register as futures commission merchants or associated persons under the Act. One commentator suggested that §32.3(a) be amended to make clear that the resale of a commodity option by an option customer to a writer does not require the customer to register as a futures commission merchant. The Commission does not interpret §32.3 as requiring the registration of option customers because of the occasional resale by an option customer to a writer and, accordingly, does not believe that an amendment to this section is necessary.

It was also suggested that §32.3(c) be amended to make clear that persons registered under the interim rules need not register as commodity trading advisors if their services are rendered on a basis solely incidental to their commodity option activities. This was the intent of §32.3(c) and to make this clear, the Commission has incorporated such an amendment in §32.3(c)(2) as adopted.

Another commentator suggested that the proposed rule be amended to provide that persons already registered as floor brokers under the Act need not register as associated persons in accordance with the terms of the interim rule. This suggestion is consistent with the provisions of Section 4k(1) of the Act and therefore the Commission has amended §32.3(d) and has added a new §32.3(e) to provide that a person registered as an associated person or a floor broker under the Act need not register as an associated person in order to comply with §32.3. In addition, as proposed, §32.3(d) provided that persons who need not register as associated persons under §32.3 by virtue of their existing registrations under the Act were nevertheless required to notify the Commission immediately in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under that section. As adopted, the Commission has deleted this requirement from §32.3(d), and, in new §32.3(e), has required the employing futures commission merchant to provide this notification to the Commission. The Commission believes that this change will reduce the number of reports which need to be filed by affected persons in order to comply with §32.3.

One commentator suggested that the Commission's determination to make it unlawful for persons to accept money and other funds from option customers unless registered as futures commission merchants was, in effect, an amendment of the Act's definition of a futures commission merchant. The Commission disagrees. Persons who come within the definition of futures commission merchant in Section 2(a)(1) of the Act are required to register as such thereunder. The Commission's adoption of the interim rules in no way alters that obligation and in no way alters the definition of futures commission merchant contained in the Act. Rather, as the Commission stated at the time of its October 8, 1976 proposal, the Commission has determined, pursuant to its plenary power to regulate commodity option transactions, to entrust options activities only to persons who meet the basic financial and other requirements of futures commission merchants and associated persons of specified futures commission merchants under the provisions of the Act and the regulations promulgated thereunder.

EXEMPTIONS

As proposed, §32.4(a) provided that, except for the provisions of §§32.2 (prohibited transactions) and 32.9 (fraud in connection with commodity option transactions), the provisions of the interim rules do not apply to certain trade option transactions. However, as will be discussed more fully below, the Commission has adopted new §§32.8(b) and (c) as explicit codifications of activity which the Commission considers presently to be violations of its anti-fraud rule. In addition, proposed §32.8, adopted as §32.8(a), was believed to have limited applicability in a trade exemption situation since it dealt with unlawful representations

as to registration. Nonetheless, since it also proscribes representations being made concerning the Commission's approval of the transaction, the Commission believes that §32.8(a), as well as the newly adopted §§32.8(b) and (c), should apply in trade exemption situations. Accordingly, the Commission has adopted the trade option transaction exemption in the form proposed, with the addition of the applicability of §32.8 thereto.

DISCLOSURE

The Commission received many comments strongly critical of the disclosure provisions of the proposed interim rule contained in §32.5. Commentators suggested that the requirement that an option customer receive the summary disclosure statement contemplated by §32.5(a) not less than 24 hours prior to the entry into the commodity option transaction was unrealistic in light of the volatile nature of the commodities markets. In addition, commentators noted that §32.5(a), which could be interpreted to require delivery of a summary disclosure statement prior to the entry into each commodity option transaction, would be unduly burdensome. Furthermore, commentators pointed out that, as proposed, §32.5 required summary disclosure of particularized price information if available, and if not available, disclosure of such information immediately upon execution of the commodity option transaction. Commentators suggested that a more practical approach would be to provide a generalized disclosure document regarding commodity option transactions prior to the entry into the commodity option transaction, with particularized data made available as part of the confirmation of the execution of the transaction. It was also suggested that the persons required to deliver the confirmatory price information be permitted to do so not later than one business day following execution of the transaction rather than "immediately".

The Commission bel[illegible] that the foregoing comments are essentially constructive and has revised §32.5 to incorporate these suggestions while retaining the basic thrust of the proposed disclosure rules. As adopted, §32.5(a) eliminates the requirement that the summary disclosure statement be furnished not less than 24 hours prior to the entry into the commodity option transaction. However, the Commission wishes to emphasize that the option customer or prospective option customer must be furnished with the summary disclosure statement prior to the entry into a commodity option transaction. Accordingly, persons who intend to mail summary disclosure statements should obtain assurances that the summary disclosure statement has been received by the option customer or prospective option customer before entering into a commodity option transaction.

In addition, as adopted, §32.5(a) eliminates the requirement that particularized price information be furnished as part of the summary disclosure statement. Rather, the summary disclosure statement shall contain (1) a brief description of the commodity option transactions being offered, including (i) the duration of the commodity options being offered and the total quantity and quality of the commodities which may be purchased or sold upon exercise of the options being offered or which underlie the contracts of sale for future delivery which may be purchased or sold upon exercise of such commodity options; (ii) a listing of the elements comprising the purchase price to be charged, including the premium, mark-ups on the premium, costs, fees and other charges, as well as the method by which the premium is established; (iii) the services to be provided for the separate elements comprising the purchase price; and (iv) the method by which the striking price is established; (2) a description of any and all costs in addition to the striking price which may be incurred by an option customer if the commodity option is exercised, including, but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise), and all similar fees and charges which may be incurred; (3) a statement to the effect that the price of the commodity or contract of sale for future delivery underlying each commodity option transaction being offered must either rise above the striking price, or fall below the striking price, as the case may be, by an amount in excess of the sum of the premium and all other costs incurred in entering into and exercising the commodity option in order for the option customer to realize a profit on the commodity option transaction; and (4) a clear explanation of the effect of any foreign currency fluctuations with respect to options which are to be executed on or through the facilities of a foreign board of trade.

As adopted, §32.5(a) retains the proposed provisions that the first page of the disclosure statement contain the boldfaced statement required by §32.5(a)(5). In addition, the summary disclosure statement must contain the statements called for by §32.5(a)(6) to the effect that specific market movements of the commodities or contracts of sale of a commodity for future delivery underlying the options being offered cannot be accurately predicted and that, generally, an option customer will be unable to sell any option purchased in any market to recover any of the purchase price, but rather may only liquidate by exercising an option before the expiration of the option. The proposed requirement that a statement be made that an option customer may also liquidate by entering into an offsetting transaction has been deleted because, generally, no such offsetting trading mechanism exists at the present time.

As adopted, §32.5(b) basically provides that the summary disclosure statement need not be provided to an existing option customer prior to entry into *each* option transaction except (1) upon request or (2) if the disclosure statement that has been previously provided to such customer has become outdated or inaccurate in any material respect. The Commission wishes to point out that §32.5(b) applies only to existing option customers and that the summary disclosure statement must be provided to *prospective* option customers who have not previously entered into a commodity option transaction with the person required to provide the statement.

Moreover, although the summary disclosure statement need not contain particularized price data, the Commission believes that where information concerning particular price information is available prior to the entry into a commodity option transaction, option customers should be informed of such information. Accordingly, the Commission has adopted §32.5(c), which specifies the price information which, if known prior to the entry into any commodity option transaction, must be disclosed to option customers and prospective option customers.

As adopted, §32.5(d) of the interim rule relates to the required confirmation statement which must be delivered to all option customers after execution of each option transaction. That section basically provides that not more than 24 hours after the execution of a commodity option transaction, a commodity option customer must be furnished, by mail or other generally accepted means of communication, a written confirmation statement which contains at least (1) the actual amount of the purchase price, including a separate listing of the premium, markups on the premium, costs, fees and other charges; (2) the striking price; (3) the total quantity and quality of the commodity which may be purchased or sold or which underlies the contract of sale for future delivery which may be purchased or sold upon exercise of the commodity option; (4) the exercise date of the commodity option purchased and, in case of an option on a contract of sale for future delivery, the final trading date on such contract; and (5) the date the commodity option was executed.

The Commission believes that the foregoing changes in the disclosure requirements of §32.5 will ameliorate many of the concerns expressed by the commentators. While the disclosure requirements have been adopted in a somewhat modified form, the Commission does not anticipate that affected persons should experience particular difficulty in complying with these revised provisions since substantially the same information will be required to be disclosed in this section as adopted as had originally been proposed. Some of the commentators objected to various aspects of the disclosure statement such as, for example, that the disclosure of markups was unwarranted, exceeded the Commission's authority and was not in accordance with normal commercial practice. The Commission's authority under §4c(b), as previously indicated, is exceedingly broad and in light of the Commission's knowledge of markups in excess of 100% being charged in some cases, the Commission deems disclosure of such items to be an essential customer protection.

One commentator suggested that, as an alternative to its disclosure requirements, the Commission encourage development of an industry-wide brochure regarding commodity options. The Commission believes that this suggestion has some merit and encourages interested persons to work on such a brochure and to comment in this regard, particularly since standardized disclosure materials appear compatible with the Commission's proposed second-stage of regulations which will be designed to restrict commodity option trading on or through the facilities of designated boards of trade in the United States and of recognized foreign options systems.

SEGREGATION

The strongest objections made to the Commission's proposed interim rules concerned the segregation requirements of 32[illegible] The criticisms can be summarized as follows: (1) segregation [illegible]e entire purchase price is unfair since receipt of at least a substantial portion of the monies obtained from customers is necessary for the options dealer to be able to continue to conduct an options business and cover the payment of employees' salaries, sales commissions, administrative expenses, fees for executing brokers, and similar charges; (2) the inability of an options dealer to have available a portion of the purchase price for day-to-day operations would encourage options dealers to offer options of a shorter duration than are presently being offered, and force them to encourage their customers to exercise existing options prematurely in order to achieve a more favorable cash flow--both practices that could possibly be detrimental to option customers; (3) only larger firms with great amounts of capital could afford to stay in business if options dealers are required to comply with the Commission's proposed segregation requirements; and (4) futures commission merchants engaged in accepting margin from option

customers trading commodity futures contracts are not required to segregate sales commissions, so that the Commission's proposal operated to discriminate unfairly against futures commission merchants engaged in options activities.

At the time of the announcement of its proposed interim rules, the Commission stated that it viewed the proposed segregation requirements as essential to protect at least the basic investment of commodity option customers as well as to assure, to the extent feasible, the financial integrity of option transactions. The Commission stressed that what is of paramount importance is that option customers be assured, at the very least, that the assets which they put up to purchase a commodity option will be safe during the term of the option, and be available to be refunded in the event that an option customer exercises the option but is unable to obtain satisfaction of the obligations owing to him because of the insolvency of his futures commission merchant or its principals. In its report to the Commission the Advisory Committee recognized and addressed this problem as follows:

> At the present time, neither United States nor London vendors of ICCH or LME member options are required to segregate funds received from United States customers. Moreover, neither the ICCH nor the LME currently guarantees to United States customers the performance of obligations on any ICCH or LME option. The Advisory Committee has been informed that these and other circumstances, such as the absence of financial requirements for option dealers in the United States and the lack of regulation of the United States market for Foreign Options, make it very difficult for United States customers to obtain redress in the United States

> from dealers of 'London' options in the event of a default on the option transaction. On this basis, the Advisory Committee has determined that, to the extent possible, these deficiencies should be remedied by the Commission." (CCH Commodity Futures Law Reporter, Special Supplement numbered 26 at pages 41-42 (July 15, 1976)).

The Commission firmly believes that by providing a minimum fund under segregation requirements, an essential customer protection, albeit a bare minimum one, will be afforded commodity option customers in the United States. Several commentators have indicated that letters of credit, bonding requirements, and other forms of financial guarantees could be used as alternatives to segregation. While the Commission believes that these suggestions are on the whole constructive, and while the Commission would urge continued efforts by commentators to suggest suitable alternatives to the segregation requirement, specific proposed alternatives have not yet been submitted which would be capable of being effectuated to coincide with the adoption of the interim rules. Accordingly, the Commission has determined to include segregation requirements in the interim rules as adopted, to provide for a minimal cash fund to be available in the United States for the benefit of option customers.

However, the Commission also realizes, as it stated at the time of its October 8, 1976 proposal, that the segregation requirements could result in so-called "double segregation", particularly with respect to the sale of London options and that affected persons will need time to take the necessary steps in order to be in compliance when the segregation requirements become effective. In addition, as the Commission also stated at that time, it had originally intended to permit futures

commission merchants to exclude sales commissions from the assets required to be segregated. The Commission is persuaded by the comments it has received that it would not be inconsistent with customer protection considerations to permit futures commission merchants to withhold a portion of the purchase price received to help meet operating expenses or the costs of any necessary financing arrangements. Accordingly, as adopted, the Commission has amended §32.6(a) to provide that up to a maximum of 10% of the money, securities or property accepted from an option customer as payment of the purchase price in connection with a commodity option transaction need not be treated and dealt with as belonging to the option customer and segregated as required by §32.6. In addition, in order to provide additional time for affected persons to be in full compliance with the segregation requirements when they become effective, the Commission has determined to adopt §32.6 effective 30 days from the date of publication of this Federal Register notice. Any affected person may, pursuant to §32.4(b), submit a written request to the Commission for exemption from the segregation requirements (or other requirements of these rules). However, any such request should be accompanied by complete and specific details of the basis upon which the exemption is requested and of the alternative to segregation which the requesting person will utilize in connection with its commodity option transactions. The Commission points out that under the terms of §32.4(b), an exemption will be granted only if the Commission finds, in its discretion, that it would not be contrary to the public interest to grant such exemption. The Commission will not, however, entertain frivolous or incomplete applications for exemption. Any bonding or letter of credit must contain a complete and unconditional obligation to the commodity option customer from an unquestionably financially sound entity before it will even be considered. The Commission has no intention of expending its limited resources on a myriad of exemption applications unless there is real substance to the proposed alternatives.

The Commission notes that one commentator suggested that a suitable alternative to segregation would be a form of commodity account insurance. On November 12, 1976, the Commission, as required by Section 417 of the Commodity Futures Trading Commission Act of 1974, submitted to the Congress its report respecting the need for legislation insuring owners of commodity futures accounts and persons handling or clearing trades in such accounts against loss by reason of the insolvency or financial failure of a futures commission merchant carrying such accounts. In that report the Commission concluded that, at this time, the need for an insurance program is minimal because the level of public confidence in the safety of customer funds in the commodity futures industry is relatively high and that the benefit-cost ratios presented in the report demonstrate that such insurance protection would not be cost effective. In part, the Commission based its conclusion on the protection afforded by the Commission regulations requiring periodic audits of futures commission merchants and the segregation of customer funds, and the minimum capital requirements imposed on futures commission merchants. However, the Commission also indicated that it would reevaluate the concept of an insurance fund from time to time and, should circumstances warrant, will be prepared to make appropriate recommendations to the Congress. In this connection, the Commission would welcome comments with respect to whether an insurance program designed to protect the accounts of option customers would be an appropriate alternative to segregation and would be willing to review a sound proposal for an insurance program to achieve this end.

At the time the Commission originally proposed that segregation requirements be part of an interim rule it indicated that such requirements might have to be modified in the second-stage of its regulations to take into account option trading on boards of trade designated by the Commission and on recognized foreign options systems. In that connection, the Commission wishes to advise affected persons that the segregation requirements adopted by the interim rules reach only the purchase price of the commodity option and do not purport to require segregation of equities accruing to the customer as a result of the commodity option transaction or of monies deposited by option customers which are not committed to a particular commodity option transaction. Accordingly, the Commission wishes to stress that the segregation requirements contained in the interim rules relate solely to the customer's basic investment in the commodity option and in no way are designed to guarantee performance of the fulfillment of the commodity option transaction to the option customer or to guarantee that there will be sufficient funds in segregation to cover accrued customer equities, or to provide that the option customer will receive the benefits of his bargain. The Commission considers it to be unlawful, and a violation of the Commission's anti-fraud rule governing commodity option transactions, 17 C.F.R. §30.01, for any person to represent to its option customer that compliance with the Commission's interim rules guarantees fulfillment of a commodity option transaction. Accordingly, the Commission deems it appropriate to codify its view in the interim rule and has adopted §32.8(b) which explicitly makes such representations unlawful.

BOOKS AND RECORDKEEPING

The Commission has adopted §32.7, concerning books and recordkeeping, substantially in the form proposed. However, commentators suggested that the Commission amend §32.7(a) to require retention of solicitation material used on radio and television. This had been intended by the Commission's proposed requirement concerning the retention of all solicitation and advertising materials. However, the Commission has amended this section to make explicit the requirements that the text of standardized oral presentations and of radio, television, seminar or similar mass media presentations be retained. In addition, by virtue of the requirement in §32.5(d), as adopted, that option customers receive confirmation statements, the Commission has included a requirement in §32.7(a) that copies of such confirmation statements be retained.

It was also suggested that it was impractical to require in §32.7(b) that persons keep a permanent record showing the true name of commodity option makers, underwriters, issuers or other persons who assume or purport to assume any financial responsibility for the fulfillment of any commodity option transaction, since the identity of such persons would often be unknown. Accordingly, the Commission has amended this section in the form adopted to require the retention of such information to the extent that such information is known or may be reasonably obtained by the person required to retain the information.

The Commission also received comments that the requirement in §32.7(a), that persons retain and furnish to the Commission upon request the true name and address of each prospective commodity option customer solicited, was unduly burdensome. The commentators believed that this requirement should be limited exclusively to option customers. The Commission disagrees. This provision imposes no greater burden than placing a check mark next to the name and address of the customer on the solicitation list utilized. Moreover, the Commisssion believes that this information, as well as its books and record-keeping requirements generally, will assist in the Commission's monitoring of the activities of persons offering commodity option transactions for compliance with the interim rules.

In view of the Commission's adoption of §32.5(d), concerning the furnishing of commodity option customers with a confirmation statement, the Commission has deleted the last sentence of proposed §32.7(d), as adopted, since the information called for by that sentence is to be furnished to the option customer as part of the confirmation statement.

UNLAWFUL REPRESENTATIONS; ~~DUE DILIGENCE~~ EXECUTION OF ORDERS

The Commission has adopted §32.8 of the proposed interim rules as §32.8(a) without change. In addition, as indicated above, the Commission has adopted §32.8(b) to make explicit the Commission's view that it is unlawful to represent that compliance with the provisions of the interim rule constitutes a guarantee of performance of the fulfillment of the commodity option transaction. Moreover, the Commission believes it to be a violation of its anti-fraud rule governing option transactions for any person, upon receipt of an order for a commodity option transaction, unreasonably to fail to secure prompt execution of such order. In order to make explicit this view, the Commission has adopted as §32.8(c) a rule specifically proscribing such activity.

ANTIFRAUD

As proposed, the Commission has incorporated its antifraud rule governing commodity option transactions in §32.9 of the interim rules. This provision has been included as part of the interim rules so that all rules affecting commodity options transactions will be in one place in the Code of Federal Regulations. Section 32.9 is the same rule that is presently in effect, 17 CFR 30.01, modified to incorporate certain of the definitions set forth in the interim rules and to delete certain unnecessary language. As the Commission indicated at the time of its proposal of the interim rules, the redesignation of §30.01 as §32.9 is technical only and will have no substantive effect on fraudulent activity prior to, on, or after the effective date of §32.9. In this connection, the Commission wishes to stress that judicial interpretations of §30.01 will, of course, continue to be applicable to new §32.9. See CFTC v. J.S. Love & Associates Options Ltd., CCH Com. Fut. L. Rep. ¶20,198 (S.D.N.Y., Aug., 12, 1976).

OPTION TRANSACTIONS ENTERED INTO PRIOR TO THE EFFECTIVE DATE OF THE INTERIM RULES

As proposed Section §32.10 was intended to make clear that the interim rules are to have prospective effect only. However, to make clear that fraudulent activity occurring after the effective date of the interim rules in connection with a commodity option transaction lawfully entered into prior to their effective date is unlawful, the Commission has adopted §32.10 to provide that nothing in the interim rules shall be construed to affect lawful activities that occurred prior to the effective date of the interim rules.

AMENDMENTS TO SECTIONS 1.3 AND 1.17

The Commission has adopted these amendments in the same form as proposed on October 8, 1976. The amendment to §1.3 of the Commission's regulations includes within the definition of "futures commission merchant" any person required to register as a futures commission merchant by virtue of the interim rules and the amendments to §1.17 require that any futures commission merchant engaging in commodity option transactions referred to in Part 32 of the Commission's regulations would be required to have, and to maintain at all times, adjusted working capital equal to or in excess of whichever of the following is greater: (1) $50,000 or (2) the sum of the safety factors described in §1.17 with respect to both proprietary and customers' accounts plus 5% of the applicant's aggregate indebtedness. A futures commission merchant who is exempt from the financial requirements of §1.17 (a) would also be required to maintain minimum adjusted working capital of at least $50,000, computed in accordance with the bylaws, rules, regulations or resolutions of the contract market which serve as the basis for such exemption. Based on its experience, as previously stated, the Commission believes that the distinction in working capital requirements between futures commission merchants who are engaging in options activity as opposed to those who are not, is necessary to provide a cushion against losses which are more likely to arise in the commodity options area. The Commission has also amended §1.17 to add a new paragraph (c) (9) defining "customer" to include "option customer" as defined in the interim rules.

§1.19

It has been suggested that Commission regulation §1.19, 17 C.F.R. §1.19, precludes futures commission merchants from dealing in commodity options in accordance with the interim rules. The Commission disagrees. Section 1.19 precludes futures commission merchants from issuing or otherwise assuming financial responsibility for the fulfillment of commodity option transactions. It does not prohibit futures commission merchants from accepting money from option customers in connection with option transactions if the futures commission merchant acts solely in an agency capacity in a commodity option transaction. However, should futures commission merchants be obligated for the fulfillment of the option upon exercise by the option customer, the futures commission merchant would be in violation of §1.19. As previously stated, the

Commission is considering the repeal of §1.19 in connection with the proposed second stage of its regulations.

* * * * *

In consideration of the foregoing, the Commission, pursuant to its authority contained in Sections 2(a)(1), 4c(a), 4c(b) and 8a of the Act, 7 U.S.C. 2, 6c(a), 6c(b) and 12a (Supp. V, 1975), hereby amends Chapter 1 of Title 17 of the Code of Federal Regulations by amending §§1.3(p) and 1.17, by deleting §30.01 and by adding a new Part 32 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. Section 1.3(p) is amended by adding a "(1)" after the word "means" and before the word "individuals", by deleting the period and adding the word "and" after the word "therefrom" and by adding the following:

§1.3 Definitions.

* * * * *

(p) * * *

(2) shall include any person required to register as a futures commission merchant under the Act by virtue of Part 32 of this chapter.

2. Section 1.17 is amended to revise paragraphs (a) and (b) and to add paragraph (c)(9) as follows:

§1.17 Minimum financial requirements.

(a) Except as provided in paragraphs (b)(1) and (b)(2) of this section, no person applying for registration as a futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) $10,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b)(1) Except as provided in paragraph (b)(2) of this section, no person registered as a futures commission merchant shall engage in commodity option transactions referred to in Part 32 of this chapter unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) $50,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each such person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(2) The requirements of paragraphs (a) and (b)(1) of this section shall not apply if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting requirements set by such contract market in its bylaws, rules, regulations or resolutions approved by the Commission: _Provided_, _however_, That a futures commission merchant who engages in option transactions referred to in Part 32 of this chapter shall at all times maintain a minimum capital of $50,000 computed in accordance with the applicable bylaws, rules, regulations or resolutions of such contract market which have been approved by the Commission.

(c) * * * (9) The term "customer" shall include an "option customer" as defined in Part 32 of this chapter.

* * * * *

PART 30--FRAUD IN CONNECTION WITH COMMODITY TRANSACTIONS

§30.01 [Removed]

1. Section 30.01 is removed.

PART 32--REGULATION OF COMMODITY OPTION TRANSACTIONS

2. Part 32 is added to read as follows:

Sec.

32.1 Definitions.

32.2 Prohibited transactions.

32.3 Unlawful commodity option transactions.

32.4 Exemptions.

32.5 Disclosure.

32.6 Segregation.

32.7 Books and recordkeeping.

32.8 Unlawful representations; execution of orders.

32.9 Fraud in connection with commodity option transactions.

32.10 Option transactions entered into prior to the effective date of this Part.

AUTHORITY: Secs. 2(a)(1), 4c(a), 4c(b), 8a, Commodity Exchange Act (7 U.S.C. 2, 6c(a), 6c(b) and 12a (Supp. V, 1975)).

§32.1 Definitions.

As used in this Part --

(a) "Commodity option transaction" and "commodity option" each means any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty" involving any commodity regulated under the Act other than wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice;

(b) "Interstate commerce" shall be construed and have the same meaning as set forth in Sections 2(a) and 2(b) of the Act;

(c) "Option customer" means any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option, but shall not include a person required to register as a futures commission merchant in accordance with this Part;

(d) "Purchase price" means the total actual cost paid or to be paid, directly or indirectly, by an option customer for entering into and maintaining an interest in a commodity option transaction, by whatever name called; and

(e) "Striking price" means the price at which an option customer may purchase or sell the commodity or the contract of sale of a commodity for future delivery which is the subject of a commodity option transaction.

§32.2 Prohibited transactions.

No person may offer to enter into, enter into, confirm the execution of, or maintain a position in, any transaction in interstate commerce involving --

(a) wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice, or

(b) any contract of sale of any commodity for future delivery traded on or subject to the rules of any contract market or involving the prices of such contracts, except under such terms and conditions as the Commission shall prescribe;

if the transaction is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

§32.3 Unlawful commodity option transactions.

(a) On and after January 17, 1977, it shall be unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as a futures commission merchant under the Act and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked.

(b) On and after January 17, 1977, it shall be unlawful for--

(1) any person to solicit or accept orders (other than in a clerical capacity) for the purchase or sale of any commodity option, or to supervise any person or persons so engaged, unless such person is--

(i) registered as a futures commission merchant under the Act, or

(ii) if such person is an individual, registered as an associated person of a specified futures commission merchant under the Act;

and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) any futures commission merchant to permit an individual to become or remain associated with such futures commission merchant as a partner, officer or employee (or in any similar status or position involving similar functions) in any capacity involving such solicitation, acceptance or supervision if such futures commission merchant knew or should have known that such individual was not registered as an associated person or that such registration has expired, been suspended (and the period of suspension has not expired) or revoked;

(c) A person required to register as a futures commission merchant or as an associated person in accordance with this section which furnishes the services specified in that portion of Section 2(a)(1) of the Act defining the term "commodity trading advisor" shall not be included in the term commodity trading advisor if:

(1) at the time such services are furnished, such person is registered as a futures commission merchant, as a floor broker or as an associated person under the Act, and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) the furnishing of such services is solely incidental to the conduct of such person's activities relating to commodity option transactions.

(d) A person registered as a futures commission merchant under the Act, who is required to register as such by virtue of this section, need not register as such in order to comply with this section, but shall immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under this section.

(e) A person registered as an associated person or as a floor broker under the Act, who is required to register as an associated person by virtue of this section, need not register as such in order to comply with this section, but the futures commission merchant employing such person shall immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under this section.

§32.4 Exemptions.

(a) Except for the provisions of sections 32.2, 32.8 and 32.9, which shall in any event apply to all commodity option transactions, the provisions of this Part shall not apply to a commodity option offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.

(b) The Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of this Part, other than sections 32.2, 32.8 and 32.9, if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption.

§32.5 Disclosure.

(a) Except as provided in paragraph (b) of this section, prior to the entry into a commodity option transaction, each option customer or prospective option customer shall be furnished a summary disclosure statement by the person soliciting or accepting the order therefor. The disclosure statement shall contain the following--

(1) A brief description of the commodity option transactions being offered including:

(i) the duration of the commodity options being offered and the total quantity and quality of the commodities which may be purchased or sold upon exercise of the options being offered or which underlie the contracts of sale for future delivery which may be purchased or sold upon exercise of such commodity options;

(ii) a listing of the elements comprising the purchase price to be charged, including the premium, mark-ups on the premium, costs, fees and other charges, as well as the method by which the premium is established;

(iii) the services to be provided for the separate elements comprising the purchase price; and

(iv) the method by which the striking price is established;

(2) A description of any and all costs in addition to the purchase price which may be incurred by an option customer if the commodity option is exercised, including, but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise), and all similar fees and charges which may be incurred;

(3) A statement to the effect that the price of the commodity or contract of sale for future delivery underlying each option transaction being offered must either rise above the striking price, or fall below the striking price, as the case may be, by an amount in excess of the sum of the premium and all other costs incurred in entering into and exercising the commodity option in

order for the option customer to realize a profit on the commodity option transaction;

(4) A clear explanation of the effect of any foreign currency fluctuations with respect to commodity option transactions which are to be executed on or through the facilities of a foreign board of trade;

(5) The following boldfaced statements on the first page of the summary disclosure statement:

BECAUSE OF THE VOLATILE NATURE OF THE COMMODITIES MARKETS, THE PURCHASE OF COMMODITY OPTIONS IS NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC. A PERSON SHOULD NOT PURCHASE A COMMODITY OPTION UNLESS HE IS PREPARED TO SUSTAIN A TOTAL LOSS OF THE PURCHASE PRICE OF THE COMMODITY OPTION. SUCH TRANSACTIONS SHOULD BE ENTERED INTO ONLY BY PERSONS WHO ARE AWARE OF THE POTENTIAL FOR LOSS AND WHO UNDERSTAND THE NATURE AND EXTENT OF THEIR RIGHTS AND OBLIGATIONS.

THESE COMMODITY OPTIONS HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE COMMODITY FUTURES TRADING COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS STATEMENT. ANY REPRESENTATION TO THE CONTRARY IS A VIOLATION OF THE COMMODITY EXCHANGE ACT AND THE REGULATIONS THEREUNDER;

(6) Statements to the effect that:

(i) specific market movements of the commodities or contracts of sale for future delivery underlying the options being offered cannot be accurately predicted, and

(ii) generally, an option customer will be unable to sell any option purchased in any market to recover any of the purchase price, but rather may only liquidate by exercising an option before the expiration date of the option.

(b) A person shall not be required to deliver the summary disclosure statement to an option customer as required by paragraph (a) of this section if a summary disclosure statement has previously been furnished by such person to the option customer: Provided, however, That notwithstanding the foregoing, a disclosure statement shall be delivered in any event (1) upon the request of the option customer, or (2) if the previously delivered disclosure statement has become outdated or has become inaccurate in any material respect.

(c) Prior to the entry into a commodity option transaction, each option customer or prospective option customer shall, to the extent the following amounts are known, be informed by the person soliciting or accepting the order therefor of the actual amount of the premium, mark-ups on the premium, costs, fees and other charges comprising the purchase price, as well as the striking price and all costs to be incurred by the option customer if the commodity option is exercised.

(d) Not more than 24 hours after the execution of a commodity option transaction, each person which accepts any money, securities or property (or extends credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction shall furnish, by mail or other generally accepted means of communication, such option customer with a written confirmation statement containing at least the following information:

(1) the actual amount of the purchase price including a separate listing of the premium, mark-ups on the premium, costs, fees, and other charges;

(2) the striking price;

(3) the total quantity and quality of the commodity which may be purchased or sold, or which underlies the contract of sale for future delivery which may be purchased or sold, upon exercise of the commodity option;

(4) the exercise date of the commodity option purchased, and in the case of an option on a contract of sale for future delivery, the final trading date on such contract; and

(5) the date the commodity option was executed.

§32.6 Segregation.

(a) Any person which accepts money, securities or property from an option customer as payment of the purchase price in connection with a commodity option transaction shall treat and deal with such money, securities and property as belonging to such option customer until expiration of the term of the option or, if the option customer exercises the option, until all rights of the option customer under the commodity option have been fulfilled. Such money, securities, and property (1) shall be separately accounted for and segregated as belonging to such option customer, (2) shall be kept in the United States, and (3) shall not be commingled with the money, securities or property of any other person, including the money, securities or property received by a futures commission merchant to margin, guarantee or secure the trades or contracts of commodity customers (as defined in §1.3(k) of this chapter) or with the money accruing to such commodity customers as the result of such trades or contracts: Provided, however, That the money, securities or property treated as belonging to an option customer may for convenience be commingled with the money, securities or property treated as belonging to any other option customer and deposited in the same account or accounts with any bank or trust company in the United States. Such money, securities and property, when so deposited with any bank or trust company, shall be deposited under an account name which will clearly show that it contains money, securities or property, segregated as required by this Part. Each person depositing such money, securities or property shall obtain and retain in its files for the period provided in §1.31 of this chapter an acknowledgment from such bank or trust company that it was informed that the money, securities and property therein are being treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such bank or trust company shall allow inspection of such accounts at any reasonable time by representatives of the Commission: Provided, further, That, up to a maximum of 10 percent of the money, securities or property accepted from an option customer as payment of the purchase price in connection with a commodity option transaction need not be treated and dealt with as belonging to the option customer and segregated as aforesaid.

(b) No money, securities or property deposited in accordance with paragraph (a) of this section shall be held, disposed of, used or treated as belonging to the depositing person or any person other than the option customers of such person: Provided, however, That such money may be invested in obligations of the United States, and in obligations fully guaranteed as to principal and interest by the United States. Such investments shall be made through an account or accounts used for the deposit of money, securities or property received from option customers and proceeds from any sale of such obligations shall be redeposited in such account or accounts. Each person which invests money belonging to option customers in obligations as described in this paragraph (b), shall separately account for such obligations and segregate such obligations as belonging to such option customers. Such obligations may only be deposited with a bank or trust company in the United States and shall be deposited under an account name which will clearly show that it contains obligations treated as belonging to option customers, segregated as required by this Part. Each person depositing such obligations shall obtain and retain in its files an acknowledgment from such bank or trust company that it was informed that the obligations are treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such acknowledgment shall be retained for the period provided in §1.31 of this chapter. Such bank or trust company shall allow inspection of the obligations at any reasonable time by representatives of the Commission.

(c) Each person which invests money treated as belonging to option customers as permitted hereunder shall keep a record showing the following: (1) the date on which such investments were made, (2) the name of the person through which such investments were made,

(3) the amount of money so invested, (4) a description of the obligations in which such investments were made, (5) the identity of the depositories or other places where such obligations are segregated, (6) the date on which such investments were liquidated or otherwise disposed of and the amount of money received on such disposition, if any, and (7) the name of the person to or through which such investments were disposed of.

(d) Persons which invest money in obligations described in paragraph (b) of this section shall include such obligations in segregated accounts at values which at no time shall be greater than current market value, determined as of the close of the market on the last preceding market day.

(e) The deposit and/or investment of money as provided in paragraphs (a) or (b) of this section shall not operate to prevent the person so depositing and/or investing such money from receiving and retaining as its own any increment or interest resulting therefrom.

(f) The amount of money, securities and property which is and which must be in a segregated account in order to comply with the requirements of this Part shall be computed by each person required to segregate such money, securities and property as of the close of each business day. A record of such computation shall be made and kept, together with all supporting data in accordance with the provisions of §1.31 of this chapter. Such computation shall be made prior to the opening of business on the next business day.

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§32.7 Books and Record Keeping.

(a) Each person which accepts any money, securities or property (or extends credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to such transactions. Such records shall at least include all orders (filled, unfilled or cancelled), signature cards, books of record, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements and confirmation statements required by §32.5 of this Part, solicitation or advertising material (including the texts of standardized oral presentations and of radio, television, seminar or similar mass media presentations), circulars, memoranda, publications, writings, and all other literature or written advice distributed to option customers or prospective option customers. Upon the request of an authorized representative of the Commission, such person shall furnish the true name and address of each commodity option customer or prospective commodity option customer solicited.

(b) Each person referred to in paragraph (a) of this section shall also keep a record in permanent form which shall show the true name and address of each maker, underwriter, issuer or other person who assumes or purports to assume any financial responsibility for the fulfillment of any commodity option transaction solicited or accepted by such person, to the extent that such information is known or may be reasonably obtained by such person.

(c) Each person which accepts an order for a commodity option transaction from a person other than an option customer, shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to the transaction. Such records shall at least include the items set forth in paragraph (b) of this section and, to the extent necessary to reflect such person's participation in the transaction, shall include all items set forth in paragraph (a) of this section.

(d) Each person which accepts an order for a commodity option shall immediately upon receipt thereof prepare a written record of such order, including an account identification and order number, and shall record thereon by time-stamp or other device, the date and time, to the nearest minute, that (1) the order is accepted, (2) the order is transmitted for execution, and (3) the order is executed.

(e) All records, memoranda and other documents required to be maintained by paragraphs (a) through (c), and to be prepared by paragraph (d), of this section shall be retained for the period specified in §1.31 of this chapter, and each person required to maintain such records shall be required to produce the same for inspection and furnish true and correct copies thereof and information and reports as to the contents or meaning thereof when and as requested by any authorized representative of the Commission or the United States Department of Justice.

§32.8 Unlawful representations; execution of orders

It shall be unlawful for --

(a) any person required to be registered with the Commission in accordance with this Part expressly or impliedly to represent that the Commission, by declaring effective the registration of such person or otherwise, has directly or indirectly approved such person, or any commodity option transaction solicited or accepted by such person;

(b) any person in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction expressly or impliedly to represent that compliance with the provisions of this Part constitutes a guarantee of the fulfillment of the commodity option transaction;

(c) any person, upon receipt of an order for a commodity option transaction, unreasonably to fail to secure prompt execution of such order.

§32.9 Fraud in connection with commodity option transactions.

It shall be unlawful for any person directly or indirectly --

(a) to cheat or defraud or attempt to cheat or defraud any other person;

(b) to make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

(c) to deceive or attempt to deceive any other person by any means whatsoever;

in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction.

§32.10 Option transactions entered into prior to the effective date of this Part.

Nothing contained in this Part shall be construed to affect any lawful activities that occurred prior to the effective date of this Part.

The foregoing adoption by the Commission of the amendments to §§1.3 and 1.17, of the deletion of §30.01, and of Part 32 shall become effective 15 days after the date this Notice is published in the Federal Register (December __, 1976), except that section 32.6 of Part 32 of the foregoing rules shall become effective 30 days after the date of publication (December __, 1976). In order to assure full and fair consideration of the various proposals that have been made over the many months in which option regulations have been considered, it has not been possible to implement appropriate regulations before now. That consideration having now been completed, however, the Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been fraught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof.

Issued in Washington, D.C. on November 12, 1976.

By the Commission.

William T. Bagley

William T. Bagley
Chairman
Commodity Futures Trading
Commission

EXHIBIT "B" TO AMENDED COMPLAINT

[¶ 2143] Reg. § 1.17. Minimum Financial Requirements.

→ *The CFTC has proposed to amend Reg. § 1.17 to reflect its regulatory scheme for commodity option transactions (at ¶ 20,217).*

(a) Except as provided in paragraph (b) of this section, no person applying for registration as futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) $10,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b) The requirements of paragraph (a) of this section shall not be applicable if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting requirements set by such contract market in its bylaws, rules, regulations or resolutions approved by the Commission.

(c) Definitions: For the purposes of this section:

(1) The term "working capital" means the amount by which current assets exceed current liabilities.

(2) The term "current assets" means cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold during the next twelve months in the normal course of operation of the principal business of the applicant or registrant, and which are available for and intended for payment of current liabilities. The term "current assets" excludes:

(i) Any unsecured customer's commodity futures account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only and which account has been in such condition for more than 30 consecutive days;

(ii) [Reserved].

(iii) Any unsecured commodity futures account, which is a "proprietary account" as defined in § 1.3(y) and which account contains a ledger balance and open trades, the combination of which liquidates to a deficit or contains a debit ledger balance only;

(iv) [Reserved].

(v) Any unsecured loan or advance on the part of applicant or registrant to any person whose account is classifiable as a proprietary account under these regulations;

(vi) Crop loan (loans made to farmers for the purpose of financing their crops or farm operations) which are not (*a*) due and collectable within nine months after the respective dates of the making of such loans, and (*b*) evidenced by legally enforceable written instruments in the possession of the applicant or registrant;

(vii) All other unsecured receivables that are not due within six months from the respective dates of their inception;

(viii) All unsecured receivables that are not collectable within six months from the respective dates of their inception;

(ix) All past due unsecured receivables;

(x) Exchange memberships, clearing house stocks and guaranty funds;

(xi) Unrealized commissions on open futures contracts;

(xii) Cash and claims to cash which are restricted as to withdrawal;

(xiii) Fixed assets, such as land, building, furniture and fixtures, improvements to real property;

(xiv) Prepaid expenses and deferred charges;

(xv) Securities without a ready market, and

(xvi) Everything excluded from such term in accord with generally accepted accounting principles.

(3) A loan or advance or any other form of receivable shall not be considered secured unless the following conditions exist:

(i) The receivable is secured by collateral which can be readily converted into cash equal to or in excess of that part of the receivable which is shown in the creditor's records as secured; and

(ii) The collateral is in the possession and control of the creditor; or

(iii) The creditor has a legally enforceable, written security agreement, signed by the debtor, and has a perfected security interest in the collateral within the meaning of the laws of the state in which the collateral is located.

(4) The term "current liabilities" means obligations that are due and payable or will become due and payable in the next 12 months, or the liquidation of which is reasonably expected to require the use of existing resources classifiable as current assets or the creation of other current liabilities. It would include any long-term loan which is not evidenced by a legally enforceable written instrument and any long-term liability that can be accelerated at the creditor's option to a term of a year or less. For the purpose of computing "working capital" within the meaning of this section, the following amounts may be excluded from current liabilities:

(i) The amount of indebtedness subordinated to the claims of all general creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as hereinafter defined; and

(ii) The amount of money, securities and property due to commodity customers, which is held in segregated accounts in compliance with the requirements of section 4d(2) of the Act and the regulations thereunder: *Provided, however,* That such exclusion may be taken only if such money, securities and property held in segregated accounts has also been excluded from current assets in computing working capital.

(5) The term "satisfactory subordination agreement" means an agreement which satisfies all the following conditions:

(i) It is a written agreement duly executed by the applicant or registrant and the lender or creditor, which agreement is legally binding and enforceable in accordance with its terms upon the lender or creditor and his creditors, heirs, executors, administrators, assigns and successors in interest;

(ii) It effectively subordinates any right of the lender or creditor to demand or receive payment or return of the cash, securities or property loaned or otherwise owed, to the claims of all present and future creditors of the registrant or applicant: *Provided, however,* With the consent of the borrower, prior to the maturity of the agreement, the lender may substitute cash or other assets, with a ready market at an equal or greater value, for the assets initially loaned, if the agreement provides for such substitution and is modified so that the substitute cash or assets are subordinated in accordance with this regulation;

(iii) The agreement shall be in effect for a period of not less than one year.

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(iv) It provides that the agreement shall not be subject to cancellation by either party, and that the loan shall not be repaid and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be to make the agreement inconsistent with the conditions of this regulation or to reduce the adjusted working capital of the applicant or registrant below the amount required by this regulation;

(v) Sole possession and control of the subordinated assets must be maintained by the borrower for the term of the agreement;

(vi) It provides that no default in the payment of interest or in the performance of any covenant or condition by the registrant or applicant shall have the effect of accelerating the maturity of the indebtedness;

(vii) It provides that any notes or other written instruments evidencing the indebtedness shall bear on their face an appropriate legend stating that such notes or instruments are issued subject to the provisions of a subordination agreement which shall be adequately referred to and incorporated by reference;

(viii) It provides that any securities or other property loaned to the registrant or applicant pursuant to its provisions may be used and dealt with by the registrant or applicant as part of his capital and shall be subject to the risks of the business; and

(ix) Copies of each such agreement and of any notes or written instruments, evidencing the indebtedness are filed, within 10 days after each such agreement is entered into, with the regional office of the Commission for the region in which the registrant or applicant maintains his principal place of business, together with a statement of the full name and address of the lender or creditor and the business relationship of the lender or creditor to the registrant or applicant.

(6) The term "adjusted working capital" means working capital less:

(i) Five percent of all unsecured receivables used by the applicant or registrant in computing his working capital;

(ii) The amount by which any advances paid by the applicant or registrant on cash commodity contracts and used in computing his working capital, exceeds 90 percent of the market value of the commodities covered by such contracts;

(iii) In the case of cash commodity inventories that are hedged by bona fide hedging positions in the futures markets (as defined in section 1.3(z) of these regulations), the amount by which the value of such inventories used by the applicant or registrant in computing his working capital, exceeds 95 percent of the market value of such inventories;

(iv) In the case of all inventories which are included as current assets and which are not hedged in futures markets, the amount by which the value of such inventories used by the applicant or registrant in computing his working capital exceeds 80 percent of the market value of such inventories: *Provided, however,* That with respect to those units of inventory that are committed to fixed price sales, there shall be no deduction from the value of such units of inventory used by the applicant or registrant in computing his working capital if the value so used does not exceed the committed sales price;

(v) The amount by which the value of securities and obligations used by the applicant or registrant in computing his working capital exceeds:

(*a*) In the case of preferred stocks, 80 percent of the market value thereof;

(*b*) In the case of common stocks, 70 percent of the market value thereof;

(*c*) In the case of commercial bonds and revenue bonds, 90 percent of the market value thereof;

(*d*) In the case of obligations of, or guaranteed by, the United States, and of general obligations of any State, or of any political subdivision thereof, 100 percent of the market value thereof;

(*e*) In the case of all other securities classifiable as current assets under this regulation, 70 percent of the market value thereof; and

(vi) That amount of subordinated borrowings and other forms of subordinated indebtedness which is in excess of 75 percent of the total of capital and subordinated liabilities.

(7) The term "aggregate indebtedness" means that portion of the total liabilities of an applicant or registrant which is not adequately collateralized, but excluding:

(i) Advances received by the applicant or registrant against bills of lading issued in connection with the shipment of commodities sold by the applicant or registrant;

(ii) Equities in partners' and officers' commodity futures accounts;

(iii) Equities in customers' commodity futures accounts segregated in accordance with the Act and regulations; and

(iv) The amount of indebtedness subordinated to the claims of all general creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as defined in this section.

(8) Liabilities shall be deemed to be "adequately collateralized" when, pursuant to a legally-enforceable written instrument, such liabilities are secured by identified assets that are otherwise unencumbered and the market value of which exceeds the amount of such liabilities by 10 percent or more.

(d) In the case of open futures contracts held in customers' accounts carried by the applicant or registrant, the safety factor shall be one-half of one percent of the market value of the greater of either the total long or total short futures contracts in each commodity in all such accounts: *Provided, however,* (1) That such safety factor shall not apply to any spread or straddle held for the same account in the same commodity, on the same market, in the same crop year, and (2) that in the case of any intermarket or intercrop year spread or straddle, or any intermarket and intercrop year spread, held for the same account in the same commodity, the safety factor shall be one-fourth of one percent of the market value of that side of each such spread or straddle having the greater market value.

(e) In the case of open future contracts held in proprietary accounts carried by the applicant or registrant, the safety factor shall be 10 percent of the market value of the greater of either the total long or total short futures contracts in each commodity in all such accounts: *Provided, however,* (1) That such safety factor shall not apply to any spread or straddle held for the same account in the same commodity, on the same market, in the same crop year, or to any contract representing a bona fide hedging transaction as defined in § 1.3(z) (however, such factor shall apply to contracts specified in paragraph (4) of § 1.3(z), representing hedges against unfilled anticipated requirements); nor shall it apply to any contract resulting from a "changer trade" made in accordance with the rules of a contract market which have been submitted to and approved by the Commission, and (2) that in the case of any intermarket or intercrop year spread or straddle, or any intermarket and intercrop year spread or straddle, held for the same

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account in the same commodtiy, the safety factor shall be 5 percent of the market value of that side of each such spread or straddle having the greater market value.

[As amended at 39 F. R. 28618, Sept. 30, 1974; 40 F. R. 11560, Mar. 12, 1975 (¶ 20,021); Jan. 21, 1976, 41 F. R. 3192 (¶ 20,130), effective Feb. 20, 1976.]

[¶ 2144] Reg. § 1.18. Records for and Relating to Financial Reporting and Monthly Computation.

(a) No person shall be registered as a futures commission merchant under the Act unless, commencing on the date his application for such registration is filed, he prepares and keeps current, ledgers or other similar records which show or summarize with appropriate references to supporting documents, each transaction affecting his asset, liability, income, expense and capital accounts, and in which (except as otherwise permitted in writing by the Commission) all his asset, liability and capital accounts are classified into either the account classification subdivisions specified on Form 1-FR or categories that are in accord with generally accepted accounting principles. Each person so registered shall prepare and keep current such records.

(b) No person shall be registered as a futures commission merchant under the Act unless he prepares, from his ledgers or other records, a trial balance as of the end of each of his month-end closing business days, commencing with the first month-end closing date after he files his application for such registration. Such trial balances shall be prepared no later than 15 days after each such closing date. Each person so registered shall continue to prepare such month-end trial balances no later than 15 days after each month-end closing date.

(c) No person shall be registered as a futures commission merchant under the Act unless he prepares, as of the end of each month-end closing date subsequent to the date of filing his application for such registration, a written computation of the total of his subordinated borrowings, the total of his long term liabilities and the total of his net worth. Such computation must be prepared no later than 15 days after the applicant's month-end closing date; and the applicant must promptly thereafter inform the Commission of the sum of such totals.

Each person registered as a futures commission merchant shall also prepare such written computation as of each month-end closing date, no later than 15 days after such day, and shall compare the sum of such totals with the sum total of the balances of such items as they appear in the report of financial condition most recently submitted to the Commission by such person in accord with paragraph (d) or (e) of § 1.10. Whenever such computation and comparison discloses that the sum total of subordinated borrowings, long term liabilities and net worth has declined 20% or more from the sum total of such items as they appear on such report of financial condition, or whenever such registrant knows or has reason to believe that he is not in compliance with the requirements prescribed in § 1.17 of these regulations, such registrant shall immediately notify the Commission thereof. For purposes of this paragraph, net worth shall mean total liabilities (including long-term debt and subordinated borrowings) deducted from total assets.

[Amended Jan. 21, 1976, 41 F. R. 3191 (¶ 20,130), effective Feb. 20, 1976.]

[The next page is 2155.]

EXHIBIT "C" TO AMENDED COMPLAINT

EXHIBIT C

Table of Estimated Financial
Requirements under Rules first
Published on November 24, 1976
as to BRITISH AMERICAN

(A)	Minimum Net Capital(1)		$ 50,000
	PLUS		
(B)	Safety Factors		
	(1) 5% of customers equity(2)	$1,200,000	
	(2) Sale short of (3) underlying futures contracts to close account option	450,000	1,650,000
	PLUS		
(C)	5% of aggregate customer indebtedness(4)		800,000
	Total (5), (6), (7)		$2,500,000

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1. The difference between current assets and current liabilities which, pursuant to the segregation requirements set forth in Reg. 32.6 and Reg. 1.17(c)(2)(xi), excludes "unrealized commissions" from current assets which, in the case of the sale of London commodity options, means that 100% of the plaintiffs' gross income for the next 6 to 18 months will be excluded and there will be no off-set to its operating expenses during this period. Reg. 1.17(c)(2)(xii) and the segregation requirements would also have the same effect. Also see Reg. 1.17 (c)(4)(ii). As to purveyors of future contracts, its customers' accounts can be turned over rapidly while options are not suitable fur churning, which is against the customer's best interests.

(Footnotes continued on Page 2)

EXHIBIT C (Footnotes continued)

2. Each commodity option, which is actually executed, as distinguished from naked options, gives the customer a right to buy or sell the underlying commodity futures contract. The exemptions set forth in Reg. 1.17(8)(d) are inapplicable to plaintiffs since they do not deal in double options (or straddles). Furthermore, under Reg. 1.17(8)(d), there is no distinction with respect to customers "in the money" and those "not in the money" (also called customer's equity in the option) and, thus, this requirement is absolute. As of the date hereof, the customers of BRITISH AMERICAN have approximately 8,000 commodity options outstanding which control 8,000 commodity futures contracts with an aggregate market value of approximately $240,000,000. The safety factor of one-half of one per cent of $240,000,000 is $1,200,000.

3. Under Reg. 1.17(8)(e), the plaintiffs, through their omnibus account, sell short a futures contract in the case of a call option or purchase long a futures contract in the case of a put option, when a customer elects to close out a transaction. However, the computation must be made on the market value of the contract and not on the market value of the option. On any given day, BRITISH AMERICAN does from 10 to 500 close-outs for its customers. Using a mean average of 150 such transactions with an average market value of $30,000 per contract equals $4,500,000, of which a 10% is required as a safety factor.

4. At the present time, the average equity per option of the customers of BRITISH AMERICAN is approximately $2,000, or a total of $16,000,000 (of which 5% is $800,000). Under Reg. 1.17(7), such amount would only be excluded if the funds are "segregated". Accordingly, the CFTC, realizing that the segregation requirements will be invalidated, are attempting to put the plaintiffs out of business by promulgating "minimum financial requirements" effective November 24th, 1976, which are scheduled to go into effect 15 days prior to the segregation requirements in Rule 32.6. Finally, if the customers of BRITISH AMERICAN should do well, this requirement would put BRITISH AMERICAN out of business since there is no way to keep raising additional capital or raising it quickly enough if there is a rapid increase in customers' equity due to sharp favorable price movement in the underlying commodity which, as a matter of public knowledge, is an extremely volatile market.

EXHIBIT C (Footnotes continued)

5. Any reputable dealer will have to carry a substantial reserve to protect it against price movements which affect both the computation of the safety factors and customers' equity

6. Even assuming, arguendo, that these requirements are reasonable and proper, the required computations (which must be made on a daily basis) will create havoc with the back offices of plaintiff BRITISH AMERICAN. Such office is computerized, and to develop a software program for these computations as to a retail commodity options dealer will cost a minimum of $100,000 and cannot possibly be developed by December 9th, 1976. A fortiori, in the case of plaintiff LLOYD, CARR, whose back office is not computerized.

7. As a result of the inherent unfairness of making a member's net capital increase in proportion to the value of customers' accounts, the New York Stock Exchange and the Securities & Exchange Commission permit an alternative basis for computing net capital based upon a percentage of cash debit balances to customers.

MEMORANDUM OF LAW IN SUPPORT OF DECLARATORY JUDGMENT

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

MEMORANDUM OF LAW IN SUPPORT OF APPLICATION FOR DECLARATORY JUDGMENT VOIDING REGULATIONS ISSUED BY COMMODITY FUTURES TRADING COMMISSION

76 Civ 5124 (Knapp)

PRELIMINARY STATEMENT

On November 24, 1976 the Commodity Futures Trading Commission (the "Commission") published in the Federal Register amendments to regulations under the Commodity Exchange Act, as amended, 7 U.S.C. 1 et seq. The explanatory preface published with said amended rules states on page 2 that all of said rules "shall become effective 15 days after publication of this notice in the Federal Register (December [9], 1976), except that the segregation provisions contained in Section 32.6 of the rules will become effective 30 days after such publication (December [24], 1976)." The registration provisions contained in Section 32.3 will become effective on January 17, 1977. No provision is made for public participation in the promulgation of such rules.

That these documents are substantive is admitted by the Commission on page 1 of its explanatory preface wherein it is stated these regulations contain "certain technical and substantive revisions." (Emphasis added) In any event in addition to the segregation provisions in Section 32.6, the disclosure provisions in Section 32.5 and the amendments making the financial requirements of Section 1.17 applicable to commodity options dealers for the first time are clearly major and substantive revisions.

Under subsections (b) and (d) of Section 553 of the Administrative Procedure Act (the "Act") the required publication date of a substantive rule is 30 days before its effective date, except in the case of "interpretative rules, general statements of policy, or rules of agency organization, procedure or practice," none of which exceptions is here applicable; or where the agency involved "for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest." 5 U.S.C. §553(b)(B).

I. THE "GOOD CAUSE" EXCEPTION IS NOT AVAILABLE IN THIS CASE.

In order to avail itself of the "good cause" exception to the 30 day publication rule, an agency must determine that compliance with such rule is either impracticable, unnecessary, or contrary to the public interest, and it must then preface the regulations with a "finding and a brief statement of the reasons therefor." Kelly v. United States Department of Interior, 339 F.Supp. 1095 (E.D. Cal. 1972). See also Texaco, Inc. v. Federal Power Commission, 412 F. 2d 740 (3d Cir. 1969); City of New York v. Diamond, 379 F. Supp. 503 (S.D.N.Y. 1974).

The Commission has quite apparently not made the necessary determination to avail itself of the "good cause" exception and has failed to preface its regulations with a finding and statement of the reasons therefor. The only statement which even gives lip service to the requirements of the Act appears at page 5 of the preface where it is stated "the Commission has determined that the public interest requires that it adopt rules regulating the offer and sale of the commodity options without further delay." Not only is such statement totally inadequate to satisfy the requirements of the Act, the 15 day publication period adopted by the Commission clearly indicates that the Commission has not determined publication to be "impracticable, unnecessary, or contrary to the public interest."

The Commission is willing to delay 15 days but not 30 days. In view of the fact that the defendants have been considering regulations relating to commodity options for over one year (see Exhibits A, B, C and D to the Affidavit of John Forma sworn to on November 16, 1976), the abrogation of the specific requirements of the Act is clearly not in the public interest. See Kelly v. United States Department of Interior (supra).

II. AN ADMINISTRATIVE RULE WHICH IS NOT PROMULGATED IN STRICT CONFORMANCE WITH THE ADMINISTRATIVE PROCEDURE ACT IS NULL AND VOID.

The Act establishes definitive procedures for the adoption of administrative rules. It has long been established that these procedures must be scrupulously followed, or the agency action taken in contravention of them is a nullity. National Motor Freight Traffic Association, Inc. v. United States, 268 F.Supp. 90 (D.D.C. 1967) (three judge court), aff'd per curiam, 393 U.S. 18, 89 S.Ct. 49, 21 L.Ed.2d 19 (1968); N.L.R.B. v. Wyman-Gordon Co., 394 U.S. 759, 89 S.Ct. 1426, 22 L.Ed.2d 709 (1969); Lewis-Mota v. Secretary of Labor, 469 F.2d 478 (2d Cir. 1972); Kelly v. United States Department of Interior, (supra); Hotch v. United States, 212 F.2d 280 (9th Cir. 1954).

The strict application of the Act is perhaps best summed up by Hotch v. United States, (supra), where the Court stated:

> "If notice of a proposed rule is not published in the Federal Register at least thirty days prior to its issuance, or if good cause is not found and published for the immediate issuance of a rule, the rule cannot be legally issued; if the rule

> itself is not published, it follows that it has not been issued; and if a rule has not been issued, it has no force as law." at page 284

WHEREFORE, the undersigned, on behalf of the plaintiffs, respectfully requests that the Court declare the regulations published by the Commodity Futures Trading Commission on November 24, 1976, to be null and void, and for such other and further relief as to the Court may seem just and proper.

Dated: New York, New York
November 30, 1976

Charles J. Hecht

Charles J. Hecht
Attorney for Plaintiffs
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

Haig Costikyan, Esq.
Of Counsel

MOTION FOR TEMPORARY RESTRAINING ORDER

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

MOTION FOR TEMPORARY RESTRAINING ORDER

76 Civ 5124 (Knapp)

Upon the Complaint and the Amended Complaint, the Memoranda of Law and all the affidavits and other papers filed, and all proceedings heretofore had herein, and the affidavit of Charles J. Hecht, Esq., attached hereto, the plaintiffs move the Court for a declaratory judgment that the rules published in the Federal Register on November 24, 1976, exclusive of Section 32.3 and Section 32.6, are null and void under 5 U.S.C. §553(b)(B) and 5 U.S.C. §553(d) or in the alternative, for an order temporarily restraining the defendants from implementing and enforcing regulations relating to commodity option transactions, pending the determination of plaintiffs' application for a preliminary injunction, and for such other and further relief as to the Court may seem just.

Dated: New York, New York
December 3, 1976

Charles J Hecht

Charles J. Hecht
Attorney for Plaintiffs
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

Haig Costikyan
Of Counsel

AFFIDAVIT OF CHARLES J. HECHT

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

AFFIDAVIT

76 Civ 5124 (Knapp)

STATE OF NEW YORK)
) SS.:
COUNTY OF NEW YORK)

CHARLES J. HECHT, being duly sworn, deposes and says:

1. I am the attorney for the plaintiffs in the above-captioned proceeding and am thoroughly familiar with all the facts and circumstances herein. I make this affidavit in support of the within motion by plaintiffs for a declaratory judgment that the rules published in the Federal Register on November 24, 1976, exclusive of Sections 32.3 and 32.6, are null and void under 5 U.S.C. §§ 553(b)(B) and (d), or, in the alternative, an order temporarily restraining the defendants, pending the determination of plaintiffs' motion for a preliminary injunction from implementing and

enforcing said regulations.

2. Exclusive of the segregation and registration provisions, defendants intend that all of the proposed regulations shall become effective on December 9, 1976, one day prior to the hearing on plaintiffs' motion for a preliminary injunction. A temporary restraining order will not prejudice anyone as the defendants have been looking into this area and contemplating regulations for almost two years.

3. It is the plaintiffs' position that as a matter of law, under 5 U.S.C. §§553(b)(B) and (d), all as more fully set forth in their Memorandum of Law filed on December 2, 1976, the regulations are void as a matter of law. To require the plaintiffs and other companies similarly situated to face the choice of expending substantial funds to comply with void regulations or defend against enforcement proceedings is the proverbial Hobson's choice!

4. Even if the Court elects to take under advisement the legality of the published notice in the Federal Register under 5 U.S.C. §553, no harm will be done by granting the temporary restraining order in order to give the Court time to make a considered determination as to this issue as well as the proposed financial record-keeping and disclosure provisions of these proposed regulations.

5. It is deponent's understanding that the defendants are taking the position that a temporary restraining order

is not proper because under Rule 1.17(b) the minimum financial requirements are only applicable to persons who are registered as futures commission merchants and, since the plaintiffs are not yet registered as futures commission merchants, they are not harmed.

6. This is a specious argument on two grounds. In the first place, this position is in direct conflict with Rule 1.17(a) which requires that no person "applying for registration as a futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of [as provided in 1.17(b)]." In addition, page 8 of the explanatory preface to the regulations provides as follows:

> "The Commission is already processing applications for registration which it has received as a result of its announcement of the proposed interim rules. A person who defers filing an application runs the risk that the application may not be processed before the January 17th deadline. Normal requirements for processing are 30 - 60 days."

Therefore, as a practical matter, the plaintiffs must raise substantial additional capital as of yesterday, which is obviously an impossibility because London commodity option dealers are faced with a concededly discriminatory, punitive, and onerous regulatory scheme. The simple question is, how can you ethically raise this kind of money without disclosing to prospective investors that there is a possibility that in the presently pending litigation, the court could uphold a portion or all of the proposed rules?

7. Due to the uncertainty of the minimum financial requirements first published on November 24, 1976, both of the plaintiffs have not yet filed their registration applications, which are for all practical purposes just about ready for filing, because they do not know whether or not they will comply with the minimum financial requirements. As the Court may recall, during the prior conference, deponent raised the question of whether or not the defendants would consider aggregate indebtedness to include customers' equity. In response to such request, the staff stated that if we had any questions, we could write down to Washington for an interpretive position. They then handed to deponent, for the first time, the regulations which would be published in the Federal Register and thus deponent was deprived of the ability to review the same prior to that conference although all of the attorneys present were waiting around for two hours while the counsel for the defendants had such new regulations in their possession. Upon reading the new regulations that evening, it became readily apparent to the undersigned, as set forth in Exhibit "C" annexed to the Amended Complaint, that for purposes of computing the minimum financial requirements, the plaintiffs would be required to add 5% of their customers' equity, which in the case of British American, is approximately $16,000,000, and that because of the success of its customers, British

American would be required to close its doors.

8. At approximately 11:30 a.m. on December 1, 1976, deponent spoke with the General Counsel and was advised that it was their contention that the computations set forth in Exhibit "C" were improper and that according to their financial analyst, they estimate that British American would require a minimum adjusted working capital of between $400,000 and $500,000 but that they needed more information. Deponent advised that the financial statements for the month ended October 31, 1976 were completed except for one minor item, and that deponent was in a position to furnish such information as the staff might need. They responded that they did not know what information the financial analyst would need and in any event, the financial analyst(s) were out in Chicago. In short, to go through the formality of submitting a formal interpretive request when not even the staff of the CFTC knows what information it needs to make its computations, would be a sham. Exhibit "C" was prepared based on the specific wording of the regulations and under those particular regulations, it is obvious that the plaintiffs have little choice but to close their doors immediately.

9. In this connection, it should be pointed out to the Court that when the undersigned ascertained that the regulations were published on Wednesday, November 23, 1976, rather than Friday, November 25, 1976, it was suggested to counsel for the defendants that the effective date be post-

poned for three days so that there would be no need to go into court to obtain a temporary restraining order because of the fact that the hearing was scheduled on December 10, 1976, which is one day after the effective date of certain portions of the proposed regulations. As of the date hereof, this suggestion has not been accepted by the defendants.

10. As a matter of common sense, since the regulations represent an integrated and interrelated regulatory scheme relating to London commodity options, it would be in the interests of judicial economy and in the best interests of the CFTC, the plaintiffs, the industry, and the general public that the regulations be considered by the Court as a single entity. It is the defendants, not the plaintiffs, who have set up this tripartite effective date schedule for various provisions. This not only places an unreasonable burden on the Court, but an unreasonable burden on plaintiffs' counsel since the defendants are well aware that during normal working hours, plaintiffs' counsel is participating in an administrative proceeding throughout this litigation.

11. With respect to the disclosure requirements set forth in Section 32.5 of the regulations, the plaintiffs and deponent realize that such requirements will not immediately put the plaintiffs out of business but their practical effect is that within a very short period, they will cause

irreparable harm to the plaintiffs because, as more fully set forth in the Affidavits of Peter Aaron and John Forma being submitted herewith, it places the plaintiffs and other companies similarly situated at a distinct competitive disadvantage as to purveyors of futures commodity contracts and brokers who sell stock options on the CBOE who are not required to make any of such disclosures as required in the proposed regulations.

12. Both the plaintiffs and the deponent have always taken the position that full and fair disclosure is a desirable end. What we object to is the fact that the plaintiffs and other persons similarly situated are being blatantly and unreasonably discriminated against plus the fact that certain of the mandated disclosure statements are clearly false and misleading. Thus, for example, Reg. 32.5(a)(6)(2) requires that the plaintiffs set forth the following statement:

> "Generally, an option customer will be unable to sell any option purchased in any market to recover any of the purchase price, but rather may only liquidate by exercising an option before the expiration date of the option."

Such a statement is clearly false and would subject each of the plaintiffs to immediate liability under the general anti-fraud provision of the Commodity Exchange Act, as amended. One only needs to follow through a call option from purchase to liquidation of the position to see the total lack of knowledge of the defendants in requiring this statement. When the customer acquires a call option, the grantor of the option is required to take a short position at the same fixed strike price. When the beneficial owner of the option (e.g., the customer) elects to sell or declare the option, in the case of "soft" options, the ICCH converts that person's option to a long futures contract at the identical strike price. At the same time the ICCH also converts the grantor's short option into a short futures contract. Therefore, on the books of the ICCH, all the options are now reflected as both a long and short option contra to each other. Immediately, the American dealer, e.g., the plaintiffs herein, goes out and sells a futures contract short on the ICCH for the benefit of the customer to close out against the long future contract for the account of its customers and the net proceeds (the customer's equity) is then transmitted to the plaintiffs who in turn transmit directly to the customer. Throughout the transactional chain at the ICCH, each option and underlying futures contract is registered and guaranteed by the ICCH. Accordingly, plaintiffs would be required to take the 1/2 of 1% haircut as a safety factor under Rule 1.17, set forth in Exhibit "C" to the Amended Complaint.

13. Another example is the requirement that the dealer set forth the effect of future revaluations of foreign currency at the time the option is offered and on the confirmation slip when the option is finally purchased by the

customer. There is a popular misconception that if the pound is devalued, it will adversely affect the equity interest of an owner of a call option with respect to a particular commodity (see copy of the New York Times article attached to the affidavit of James Carr submitted with the original application in connection with the old rules). However, in fact, as to persons who owned coffee options in the last six months, they actually benefitted from the devaluation of the pound because the price per pound after computing the devaluation was more than offset by a substantial price increase in the underlying commodity which most people felt was a direct cause of the devaluation of the London pound. There is absolutely no way of predicting the effect of either an upward or a downward revaluation of the London pound compared to the American dollar and its effect on the value of a commodity or a commodity option. In determining the price of a commodity on the world markets vis-a-vis the London markets, foreign currency exchange ratios is only one of many factors which are determinative of the price at a given moment. Accordingly, to require the plaintiffs and other dealers to accurately describe the effect of currency revaluations to its customers in a disclosure statement in the method required by the defendants for all practical purposes subjects them to substantial civil and criminal liabilities under the general anti-fraud statute. Both plaintiffs now utilize a general statement to the effect that customers may bear some risk or reward due to currency revaluations.

14. No previous application has been made for the relief herein requested. The proposed regulations as published in the Federal Register on November 24, 1976 were first given to affiant in Court during oral argument on the afternoon of November 23, 1976, although defendant's counsel and affiant were there for almost two hours prior to oral argument.

WHEREFORE, deponent respectfully requests that the Court declare that the regulations published on November 24, 1976 be declared null and void and/or in the alternative, to grant plaintiffs' request for a temporary restraining order pending the determination of plaintiffs' motion for a preliminary injunction.

Charles J. Hecht

Charles J. Hecht
Attorney for Plaintiffs
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

Sworn to before me this
3d day of December, 1976.

Kathryn Lane
Notary Public

KATHRYN LANE
NOTARY PUBLIC, State of New York
No. 41-7418025
Qualified in Queens County
Cert. filed in New York County
Term Expires March 30, 1978
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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS
CORP. and LLOYD, CARR & CO.,

Plaintiffs

- against -

WILLIAM T. BAGLEY, Chairman of the
COMMODITY FUTURES TRADING COMMISSION;
JOHN V. RAINBOLT III, Vice Chairman
of the COMMODITY FUTURES TRADING
COMMISSION; READ P. DUNN, GARY
SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES
TRADING COMMISSION,

Defendants.

AFFIDAVIT OF JOHN FORMA
IN SUPPORT OF A TEMPORARY
RESTRAINING ORDER

76 Civ 5124

STATE OF NEW YORK)
) SS.:
COUNTY OF NEW YORK)

JOHN FORMA, being duly sworn, deposes and says:

1. I am the President of British American Commodity Options Corp. ("British American"), one of the plaintiffs herein and submit this affidavit in support of a temporary restraining order and declaratory relief, to temporarily enjoin the Commodity Futures Trading Commission from implementing and enforcing certain portions of the proposed regulations relating to commodity options published in the Federal Register on November 24, 1976 and scheduled to become effective on December 9, 1976.

2. Deponent believes that British American, which

began operations in October, 1975, is the largest company in the United States specializing in London commodity options.

3. Not even British American can come close to complying with the proposed minimum financial requirements, as described in Exhibit "C" annexed to the Amended Complaint. Admittedly, the computations involved are extremely complex but, as advised by my counsel, not even the staff of the defendants is able to tell us in what way our computations are wrong or what data they need to compute our minimum financial requirement.

4. To make matters worse, the defendants have superimposed upon option dealers financial requirements and computations which have absolutely no relationship to the operations of London commodity option dealers or the protection of the investing public. Simply stated, they do not have any understanding of our method of operations.

5. By publishing on November 24, 1976 a different timetable for the minimum financial requirements and the segregation requirements, under Rule 1.17(b) the defendants are now requiring the plaintiffs for the first time to add 5% of the customer's equity as additional working capital, which in the case of British American increases our minimum financial requirements by $800,000.

6. To deponent's knowledge, British American was the first commodity option dealer who was willing to publicly participate in the rule-making process as shown by our

letter furnished to the defendants on March 10, 1976, which is annexed to the affidavit of Charles J. Hecht, sworn to on November 15, 1976. It is in the best interests of British American, its existing customers, its future customers and the general public that proper and reasonable steps be taken to safeguard purchasers of London commodity options. The regulations, as presently framed, are not a solution. By merely puttting us out of business without any reasonable chance of raising the required capital, which as a practical matter is not required or related to customer protection, is not regulation. It is confiscation of my property without any due process. At least a temporary restraining order will permit the Court time to properly consider the issues raised in our motion for a preliminary injunction relating to a complex and integrated regulatory scheme without predetermining the issues.

7. Many of the requirements set forth in Section 32.5 are, in my opinion, based upon the marketing literature which is being utilized for British American since January, 1976. It is in our best interests that our actual and potential customers be fully educated as to London commodity options. In any event we have now prepared in draft form what we believe is a proper confirmation slip and if required will be in a position to use this within 10 days. This plus hard work was the cornerstone to build up a successful business.

8. All that we ask is a chance to compete with other

similar investment forms (CBOE options and futures contracts) who are not saddled with such slanted disclosure requirements. Although there is no way to accurately forecast the extent of the damage to existing customers or potential customers it is obvious that this will have a substantial adverse impact while our costs of operation remain constant. Once an existing or potential customer is lost the damage to any business is irreparable.

9. During the last four business days, deponent has received two offers from existing dealers of London commodity options to purchase their companies for much less than their real value as they have taken the position that under the regulatory scheme and the attitude of the defendants, this is not a viable business. However, as British American has shown, this is an extremely viable business. I just do not think it should be given to persons who have sat on the sidelines while we have done the dirty work to pick up the pieces for practically nothing because a federal regulatory agency does not know what it is doing or how to properly discharge its regulatory functions. Their attempt to sneak these regulations through on a piecemeal basis without the opportunity for meaningful public participation or proper consideration by the Court is not the way a governmental agency should function.

John Forma
John Forma

Sworn to before me this
3d day of December, 1976.

Haig Costikyan
Notary Public

HAIG COSTIKYAN
Notary Public, State of New York
No. 60-0775375 Qual. Westchester Co.
Commission Expires March, 30, 1977

MOTION FOR SUMMARY JUDGMENT

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP., and LLOYD, CARR & CO.,

Plaintiffs,

v.

WILLIAM T. BAGLEY, Chairman of the Commodity Futures Trading Commission; JOHN V. RAINBOLT II, Vice Chairman of the Commodity Futures Trading Commission, READ P. DUNN, GARY SEEVERS, and ROBERT L. MARTIN, Commissioners of the Commodity Futures Trading Commission,

Defendants.

Civil Action No.
76 Civ. 5124 (WK)

NOTICE OF MOTION

TO: CHARLES J. HECHT, ESQ.
Attorney for Plaintiffs
60 East 42nd Street
Suite 1760
New York, New York 10017

PLEASE TAKE NOTICE, that upon the annexed Statement of Material Facts As To Which There Is No Genuine Issue and certified copies of documents in the official files of the Commodity Futures Trading Commission relating to regulations adopted at 41 Fed. Reg. 51808, et seq. (November 24, 1976), the Memorandum in support hereof, and the Complaint, Amended Complaint, and all other pleadings and papers filed and proceedings heretofore had in the above-captioned action, defendants will move for summary judgment in their favor, pursuant to Rule 56 of the Federal Rules of Civil Procedure, before the Honorable Whitman Knapp, United States District Judge, in Room 307 of the United States Courthouse, Foley Square, New York, New York, on the 10th day of December, 1976, at 3:30 p.m. that day, or as soon thereafter as counsel can be heard.

[illegible]
Associate General Counsel

Commodity Futures Trading
Commission
2033 "K" Street, N.W.
[illegible]

December 3, 1976

STATEMENT OF MATERIAL FACTS

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP.,
and LLOYD, CARR & CO.,

Plaintiffs,

v.

WILLIAM T. BAGLEY, Chairman of the
Commodity Futures Trading Commission;
JOHN V. RAINBOLT II, Vice Chairman
of the Commodity Futures Trading
Commission; READ P. DUNN, GARY SEEVERS,
and ROBERT L. MARTIN, Commissioners of
the Commodity Futures Trading Commission,

Defendants.

Civil Action No.
76 Civ. 5124 (WK)

STATEMENT OF MATERIAL FACTS AS TO WHICH THERE IS NO GENUINE ISSUE

Pursuant to Rule 9(g) of the General Rules of this Court, defendants set forth below, in support of their motion for summary judgment, a statement of material facts as to which they contend there exists no genuine dispute:

1. The Commodity Futures Trading Commission is an independant regulatory agency of the United States created under the Commodity Futures Trading Commission Act of 1974, 88 Stat. 1389, which extensively amended the Commodity Exchange Act. Defendants William T. Bagley, John V. Rainbolt II, Read P. Dunn, Gary Seevers, and Robert L. Martin are the five Commissioners of that agency. Since April 21, 1975, the Commission has been responsible for administering and enforcing the provisions of the Commodity Exchange Act, as amended ("the Act").

2. Under Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975), the Commission has been given "exclusive jurisdiction" to regulate "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' . . .), and transactions involving contracts of sale of a commodity

for future delivery . . . ." The legislative history of the 1974 amendments to the Commodity Exchange Act, among other things, reflects Congress' intent that commodity option transactions be regulated fully by the Commission. The scope of the Commission's pervasive power to regulate commodity options is set forth in Section 4c(b) of the Act, 7 U.S.C. §6c(b) (Supp. V, 1975), which provides in pertinent part that:

> "No person shall offer to enter into, enter into or confirm the execution of, any (commodity option) transaction . . . contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe . . . ."

Under this section the Commission can prohibit all commodity option trading, permit all forms of commodity option trading subject to such requirements as it choses to prescribe, or allow some forms of trading under certain terms and conditions and prohibit others. The Commission is also vested under Section 8a(5) of the Act, 7 U.S.C. §12a(5) (Supp. V, 1975) with broad general rulemaking authority. That section empowers the Commission ". . . to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of [the Act] . . . .".

3. A commodity option gives the purchaser the right, during a specified period of time, to buy and/or to sell, at a set price, a specific futures contract or, in the case of an option on an actual commodity, a specific quantity of that commodity. Plaintiffs British American Commodity Options Corporation and Lloyd Carr & Co. are corporations engaged in the offer and sale of so-called "London commodity options." This type of option relates to futures contracts in commodities traded on the London commodity markets. London options are sold on or through a member of one of the London commodity markets

and are cleared through the International Commodity Clearing House in London, or are issued by or through an individual member of the London Metals Exchange.

7. On October 22, 1975, the Commission announced that it was considering the adoption of rules to regulate--or perhaps forbid--transactions in commodity options. General notice of the Commission's proposed rulemaking was published in the Federal Register on that date. 40 Fed. Reg. 49630. The notice referred to Sections 4c(b) and 2(a)(1) of the Act as the legal authority for promulgating regulations relating to commodity option transactions and set forth a description of the subjects and issues involved respecting several possible regulatory alternatives under consideration. Interested persons were invited to participate in the rulemaking process by submitting written comments to the Commission on options trading in general, the merits of the regulatory alternatives outlined by the Commission in the notice, and what, if any temporary rules might be promulgated to expand regulatory protections for option customers. The Commission's general attitudes toward the various proposed approaches were also set forth in the notice, a copy of which is annexed as Exhibit D to Defendants' Memorandum in Support of Their Motion for Summary Judgment, and incorporated herein by reference.

8. In the October 22, 1975 release, the Commission also indicated that it had assigned to an Advisory Committee on Definitions and Regulation of Market Instruments, the responsibility to study and make appropriate recommendations to the Commission concerning commodity options.

9. On February 20, 1976, the Commission proposed the adoption of comprehensive regulations governing commodity option transactions. Notice of the proposed regulations was published in the Federal Register on that date, 41 Fed. Reg. 7774, a copy of which is annexed as Exhibit E to Defendants' Memorandum and incorporated herein by

reference. The notice included the specific terms of the proposed regulations, discussed the substance, effect and basis for the regulations and cited the statutory provisions under which the rules were proposed. The proposed regulations contained registration, recordkeeping and minimum financial requirements for commodity option dealers as well as a provision designed to effect disclosure of pertinent information about the dealer to option customers. Although these proposed regulations did not include provisions for the segregation of customer funds or delivery of a disclosure statement to prospective option purchaser, the Commission nevertheless requested public comment on the merits of whether such requirements should be imposed in addition to soliciting public views on the particular sections of the proposed regulations. The Commission also announced in the February 20 notice that it would hold an oral hearing to afford further opportunity for the public to make presentations on the proposed regulations. The notice stated that the oral hearing would be held on March 8 and 9, 1976 and in the Commission's offices in Washington, D. C.

10. Numerous public comments were received by the Commission in response to both its October 22, 1975 and February 20, 1976 proposals, and interested persons, including counsel representing plaintiff British American, participated and testified at the March 8, 1976 oral hearing.

11. On July 6, 1976, the Advisory Committee established by the Commission transmitted its report on commodity options trading to the Commission. Plaintiff British American had offered written comments to the Advisory Committe in the course of its deliberations.

12. The Advisory Committee report provided a detailed analysis of the economic and other factors relating to all aspects of commodity options trading that might occur in the United States. Based on its [illegible] study, the Advisory Committee [illegible] of

options trading should be prohibited provided that a showing could be made, to the satisfaction of the Commission that, with respect to each catagory of option trading, certain basic customer protections substantially equivalent to those afforded futures customers on designated contract markets, were provided to option customers. The Advisory Committee determined such protections to be, among other things, registration of option dealers with the Commission, minimum working capital and net worth requirements for option dealers, physical segregation of customers monies and property and of unrealized net equity in customer accounts, and the furnishing of a basic disclosure statement to prospective option purchasers, which included a description of mark-ups, charges and commissions.

13. After consideration of the public comments received on its prior proposals, the presentations made at its oral hearing on March 8, 1976, and the report and recommendations of its Advisory Committee, the Commission published proposed interim option regulations on October 8, 1976. 41 Fed. Reg. 44560 (October 8, 1975). The Federal Register notice of October 8, 1976, is annexed as Exhibit F to the Commission's memorandum and is incorporated herein by reference. That notice contained the specific terms of the proposed interim regulations and provided a detailed presentation of the regulatory judgments made by the Commission, the basis upon which those judgments were made, the purposes to be achieved by the interim regulations, and their relationship to the Commission's objective of establishing a regulatory framework for a rigidly-controlled, three-year pilot program restricting commodity options transactions to domestic boards of trade and foreign commodities exchange systems which satisfied stringent self-regulatory requirements. Although the Commission expressed its intention to adopt and make effective the proposed interim regulations by November 22, 1976, the notice solicited

interested persons to submit written comments on the proposed rules by November 8, 1976. Plaintiff British American submitted written comments in response to this notice.

14. On November 22, 1976, the Commission adopted the final regulations for commodity option transactions in substantially the form proposed on October 8, 1976; they were published in the Federal Register on November 24, 1976. 41 Fed. Reg. 51808. The regulations were adopted by the Commission following certain revisions to the rules which the Commission determined necessary following consideration of all the comments received, including those submitted by counsel for British American. In the notice, a copy of which is attached as Exhibit A to the Commission's Memorandum and is incorporated herein by reference, the Commission addressed each of the significant comments received with respect to the regulations and set forth a comprehensive statement with regard to the factors and policy considerations upon which it exercised its considered judgment to impose, in the regulations, registration, segregation, disclosure, minimum working capital and other requirements upon persons engaged in the offer and sale of commodity options. The Commission found that the public interest required that the rules be adopted without any further delay inasmuch as the public had been without the protection of a comprehensive regulatory program in an area which has historically been fraught with abuses. For that and other reasons stated in the notice, it announced its determination that with the exception of the segregation provivions of §32.6, the regulations would become effective 15 days after publication. The segregation provision was adopted to be effective 30 days after publication.

Respectfully submitted,

Frederic T. Spindel

Commodity Futures Trading
Commission
2033 "K" Street, N.W.
Washington, D.C. 20581

(202) 254-9880

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP.,
and LLOYD, CARR & CO.,

Plaintiffs,

v.

WILLIAM T. BAGLEY, Chairman of the Commodity Futures Trading Commission; JOHN V. RAINBOLT, II, Vice Chairman of the Commodity Futures Trading Commission, READ P. DUNN, GARY L. SEEVERS, and ROBERT L. MARTIN, Commissioners of the Commodity Futures Trading Commission,

Defendants.

Civil Action
76 Civ. 5124 ([illegible])

DEFENDANTS' MEMORANDUM IN SUPPORT OF THEIR MOTION FOR SUMMARY JUDGMENT

In this action, plaintiffs British American Commodity Options Corporation ("British American") and Lloyd, Carr & Co. ("Lloyd Carr") seek pre-enforcement judicial review of regulations relating to commodity options adopted on November 22, 1976, by the Commodity Futures Trading Commission, the federal agency charged with administering the Commodity Exchange Act, as amended ("the Act"), 7 U.S.C. §§1-22 (Supp. V, 1975). The challenged regulations--17 C.F.R. §§1.3, 1.17, 32.1-32.10, 41 Fed. Reg. 51808, 51814-51817 (November 24, 1976)[1]--were adopted by the Commission pursuant to Sections 2(a)1, 4c(a) 4c(b) and 8a of the Commodity Exchange Act, as amended, 7 U.S.C. §§2, 6c(a), 6c(b) and 12a (Supp. V, 1975). They generally set forth the terms and conditions under which transactions in commodity options will be permitted, by imposing registration, financial, segregation, disclosure, recordkeeping and antifraud requirements upon persons who wish to engage in the business of offering and selling commodity options to the public after the effective dates of these regulatory provisions.[2]

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[1] The *Federal Register* notice publishing these regulations is attached hereto as Exhibit A.

Plaintiffs have demanded a declaratory judgment that the regulations were promulgated without compliance with the rulemaking procedures of the Administrative Procedure Act, are otherwise "in violation" of 5 U.S.C. §706(2), et seq., and are therefore invalid. Plaintiffs further seek orders preliminarily and permanently enjoining the defendants--the five individual members of the Commodity Futures Trading Commission[3]--from implementing and enforcing the regulations. The grounds for relief asserted in the Amended Complaint are basically that: (1) the promulgation of these regulations by the Commission was "arbitrary, capricious, an abuse of discretion" and "unwarranted by the facts" since the regulations allegedly impose unduly burdensome obligations which bear no relationship to the business operations of plaintiffs and other vendors of commodity options, and are wholly unnecessary to the "proper protection of customers" or to any other regulatory objective; (2) in adopting the regulations, the Commission allegedly acted in excess of its statutory authority under Section 4c(b) of the Act, 7 U.S.C. §6c(b) (Supp. V, 1975), and also allegedly violated the requirement of Section 15 of the Act, 7 U.S.C. §19 (Supp. V, 1975), that it endeavor to "utilize the least anti-competitive means" to effectuate the statutory purposes, when it imposed allegedly anti-competitive requirements which discriminate against plaintiffs; (3) the regulations were allegedly adopted without observance of procedural requirements of the Administrative Procedure Act, as codified, 5 U.S.C. §553(b)(B) (1970) and 5 U.S.C. §553(d) (1970), since plaintiffs and other interested persons were not afforded the opportunity to submit comments on the regulations, and the Commission did not comply with the requirement to state "good cause" for permitting the regulations with certain exceptions, to become effective 15 days after publication; and (4) the regulations allegedly deprive plaintiffs of their property without constitutional due process by imposing requirements which will put plaintiffs and similarly situated vendors of commodity options out of business and by failing to set forth standards for granting or denying exemptions from the regulatory requirements.

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[2] With the exception of the segregation provision in §32.6, which will become effective on December 27, 1976, the effective date of the regulations is December 9, 1976. 41 Fed. Reg. at 51817 (November 24, 1976). However, under §32.3, persons who accept customer funds in connection with a commodity option transaction are not required to be registered with the Commission as a "futures commission merchant" until January 17, 1977. Id. at 51814. In addition, since the minimum adjusted working capital requirement in §1.17(b)(1) applies, by its terms, only to persons registered as futures commission merchants, mandatory compliance with that provision is deferred until registration is obtained. Id.

[3] Unless the context otherwise requires, the term "Commission" shall hereinafter refer to all of the defendant-Commissioners as well as the Commission itself.

Plaintiffs have moved this Court for a preliminary injunction staying the effectiveness of the regulations and their enforcement by the Commission. In response, the Commission has moved for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure. This memorandum is submitted in support of the Commission's motion.

STATEMENT

On October 23, 1974, Congress enacted the Commodity Futures Trading Commission Act of 1974, 88 Stat. 1389. That legislation extensively amended the Commodity Exchange Act, 7 U.S.C. §§1-17b (1970), and created the Commission as an independent federal regulatory agency, which since April 21, 1975, has been responsible for administering and enforcing the provisions of the Act, as amended. Prior to the 1974 amendments, the Act had been administered by the Commodity Exchange Authority of the Department of Agriculture, and applied only to trading in certain specifically-enumerated agricultural commodities.[4/] The 1974 amendments greatly expanded the coverage of the Act to encompass virtually all previously unregulated commodities, by bringing within its scope "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in . . . ."[5/]

Those amendments also greatly expanded the regulatory authority of the Commission as compared to its predecessor and gave the Commission "exclusive jurisdiction" to regulate:

> "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' . . .), and transactions

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4/ Those commodities were wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. 7 U.S.C. §2 (1970).

5/ Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975).

> involving contracts of sale of a commodity for future delivery . . . ." 6/

The main area of Commission responsibility relates to contracts of sale of commodities for future delivery traded or executed on boards of trade, i.e. commodity exchanges, that have been designated by the Commission as "contract markets" for specific commodity futures contracts. 7/

It is unlawful to effect a commodity futures transaction otherwise than by or through a member of a board of trade that has been designated as a contract market by the Commission. 8/ In order for a board of trade to obtain designation as a contract market for a particular commodity futures contract, it must meet rigid requirements and must continue, after designation, to maintain specific standards, including enforcement of its rules, preventing manipulation and cornering of the market and maintaining a clearing system to secure the financial integrity of futures contracts by guaranteeing performance of trades made in such contracts. 9/ In addition, futures commission

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6/ Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975).

7/ A "board of trade" is defined in Section 2(a)(1) of the Commodity Exchange Act, 7 U.S.C. §2 (Supp. V, 1975), as

> " . . . any exchange or association, whether incorporated or unincorporated, of persons who shall be engaged in the business of buying or selling any commodity or receiving the same for sale on consignment . . . ."

8/ Section 4 of the Act, 7 U.S.C. §6 (Supp. V, 1975).

9/ See Sections 5 and 5a, 7 U.S.C. §§7, 7a (Supp. V, 1975).

merchants[10] and other professional participants in the markets must register with the Commission and comply with antifraud, reporting and recordkeeping provisions.[11] Futures commission merchants are also subject to minimum capital requirements and must segregate customer funds.[12]

In contrast to the long-established system of regulation over the organized commodity exchanges and the panoply of financial and other protections afforded to members of the public trading on designated contract markets, the selling of commodity options to the public, which has developed over the past 15 years, has not been subject to comprehensive regulation by any governmental agency.[13]

10/ A "futures commission merchant" is defined in Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975), as an individual or entity

> ". . . engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom . . . ."

11/ *See, e.g.*, Sections 4b, 4d, 4e, 4f, 4g, 4i, 4k, 4m and 4n, of the Act 7 U.S.C. §§6b, 6d, 6e, 6f, 6g, 6i, 6k, 6m, 6n (Supp. V, 1975).

12/ See Regulation 1.17, 17 C.F.R. §1.17 (1976); Section 4d of the Act, 7 U.S.C. §6d (Supp. V, 1975).

13/ A commodity option gives the purchaser the right, during a specified period of time, to buy ("call") and/or sell ("put") at a set price a specific futures contract or, in the case of an option on an actual commodity, a specific quantity of that commodity. In the case of so-called "London options" of the type offered by plaintiffs here, the option relates to futures contracts on commodities traded on the London commodity markets.

The Commodity Exchange Authority, the predecessor to the Commission, did not have jurisdiction over options on any commodities other than those specifically enumerated in Section 2(a)(1) of the Commodity Exchange Act; as to those enumerated commodities, option trading was prohibited and continues to be prohibited. See Section 4c(a) of the Act, 7 U.S.C. §6c(a) (Supp. V, 1975). Prior to the enactment of the commodity option provisions that are now contained in Section 4c(b) of the Act, 7 U.S.C. §6c(b), however, neither the Commodity Exchange Authority nor any other governmental agency had the power effectively to regulate options on other commodities.[14/] To fill this "regulatory gap," the 1974 amendments to the Act reflected a Congressional effort, among other things, fully

> ". . . to regulate trading . . . in options relating to commodities or commodity futures, because such trading is now poorly regulated, if it is regulated at all . . . ." 15/

The Congressional intent that commodity option trading be regulated completely and effectively arose out of scandals that had occurred in the late 1960's and early 1970's, which involved the financial failure of firms that sold options for which no underlying futures contract had been purchased. The House Committee on Agriculture reported that commodity customers had been defrauded of millions of dollars after having been told that they were purchasing the "right"

14/ See Section 4c(a)(B) of the Act, 7 U.S.C. §6c(a)(B) (1970) and (Supp. V, 1975).

The Commodity Exchange Authority had jurisdiction only over those agricultural commodities listed in note 4, *supra*.

15/ 120 Cong. Rec. H10247 (daily ed., Oct. 9, 1974).

to buy or sell commodity futures contracts--a right for which they had paid a premium. The premiums had not been large and, since there were no margin calls, the option firms had attracted many customers. Because it was relatively more expensive to purchase a commodity futures contract, many option firms had written options without "covering" their obligation by the acquisition of an offsetting position in the futures market. The House Committee noted:

> "It has been documented that, in some of these firms, customers who desired the proceeds of their transaction in these options were actually paid in many instances from other customer's accounts, and eventually the pyramid structure created, where one customer's account is robbed to pay another, collapses . . . ." 16/

Several persons testified before the Senate Committee on Agriculture and Forestry that, except for regulatory provisions relating to securities, no provision of federal or state law appeared to have had even arguable application to option activities. Thus, in an attempt to deal with increasing fraudulent activity involving commodity options, for which no other remedy appeared, securities laws provisions were invoked. But state blue sky laws and the federal securities laws had not been designed to deal with commodity options,17/ and had proved generally ineffective for the purpose.18/ For this reason it was suggested that the new Commission

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16/ H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 38, 37 (1974); *See also* *Hearings on H.R. 11955 before the House Committee on Agriculture*, 93d Cong., 2d Sess., ser. 93-TT, at 181-182, 194-196 (1974); *Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry*, 93d Cong., 2d Sess. pt. 1, at 224-225, pt. 3, at 682-683, 830-835 (1974) (testimony of Tom Maher and Glenn Willet Clark, and statement prepared by James Ryan and Richard Malm).

17/ *See*, *e.g.*, *Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry*, 93d Cong., 2d Sess., pt. 1, at 224-225 (1974) (testimony of Tom Maher).

18/ *Id.*, pt. 3, at 682-683 (testimony of Glenn Willet Clark) and 830-835 (statement prepared by James Ryan and Richard Malm).

be given broad and exclusive authority to regulate commodity option transactions.[19]

In response to testimony in hearings on the 1974 amendments that commodity option transactions may serve an economic purpose,[20] Congress vested the Commission with pervasive authority over options relating to all commodities which would newly become subject to the Act by reason of the 1974 amendments, mandating that the Commission determine whether option transactions should be permitted and, if so, under what circumstances. This statutory authority is set forth in Section 4c(b) of the Act, 7 U.S.C. §6c(b) (Supp. V, 1975), which provides in pertinent part:

> "No person shall offer to enter into, enter into, or confirm the execution of, any [commodity option] transaction . . . contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe . . . ."

This provision is complemented by general rulemaking authority contained in Section 8a(5) of the Act, 7 U.S.C. §12a(5) (Supp. V, 1975), which broadly empowers the Commission

> "to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of [the Act] . . . ."

Under these sections the Commission could have prohibited all commodity option trading, permitted all forms of commodity option trading subject to such requirements as it chose to prescribe, or, as it has done here, allowed some forms of trading under certain terms and conditions and prohibited others.

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[19] See generally Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., ser. 93-TT, at 194-196, 329 (1974).

[20] See Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., ser. 93-TT, at 37, 40-41, 133, 176-180, 199, 251, and 329 (1974).

The commodity option regulations adopted by the Commission on November 22, 1976, 41 Fed. Reg. 51808, 51814-51817 (November 24, 1976), reflect the Commission's considered judgment as to the regulatory approach necessary and appropriate in the public interest for permitting commodity option transactions in this country. These regulations have been promulgated after 19 months of extensive Commission study of the complex economic and other factors related to the offer and sale of commodity options in the United States. This process has consumed substantial Commission resources and has involved broad public participation.

On April 25, 1975, just four days after it came into existence, the Commission proposed an antifraud rule relating to commodity options and solicited written public comments on the proposal. 40 Fed. Reg. 18187 (April 25, 1975). After considering all the comments received, the Commission, on June 24, 1975, adopted an antifraud rule broadly proscribing fraudulent and deceptive practices and the making of false statements in connection with commodity option transactions. 17 C.F.R. §30.01 (1976), 40 Fed. Reg. 26504 (June 24, 1975).[21/] In the release

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[21/] These *Federal Register* notices are attached hereto as Exhibits B and C.

announcing the adoption of this antifraud rule, the Commission emphasized that, since the Commission had been granted exclusive jurisdiction with respect to option transactions, there existed a regulatory gap which was necessary to close as quickly as possible.[22/]

Thereafter, on October 22, 1975, the Commission announced that it was considering th[illegible]ion of rules to regulate--or perhaps forbid--transactions in [illegible] options, and had assigned to its Advisory Committee on the Definition and Regulation of Market Instruments ("the Advisory Committee") the responsibility to study and make appropriate recommendations to the Commission on the subject of commodity options. 40 Fed. Reg. 49360 (October 22, 1975).[23/] Because of the proliferation of commodity option offerings, which appeared in most cases not to be attended by adequate assurances that the issuers of options would be able to perform their obligations, the Commission recognized the apparent necessity to expand regulatory protections for option customers beyond those then afforded by its antifraud rule. Accordingly, while the Commission believed it would be inappropriate for it to make any definitive judgment concerning commodity options without thorough study, the Commission requested written public comments concerning what, if

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[22/] For this reason, the Commission stated it would be contrary to the public interest to delay effectiveness of the antifraud rule for the 30 days normally required under the Administrative Procedure Act. 40 Fed. Reg. 26504, 26506 (June 24, 1975).

[23/] The Federal Register notice announcing the Commission's proposal is attached hereto as Exhibit D.

any, temporary rules might be promulgated. For this purpose, comments were solicited both as to option trading in general and on the merits of several specific regulatory alternatives.[24/] The Commission also requested commentators to address specific economic considerations relating to commodity options[25/] and, pertinent to issues raised in the

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[24/] The alternatives proposed were:

1. prohibiting all commodity option transactions;
2. restricting commodity option transactions to contract markets;
3. forbidding option transactions except in accordance with a business plan that has been approved by the Commission;
4. prohibiting "naked" options; and
5. forbidding commodity option transactions by any person not registered with the Commission as a futures commission merchant.

40 Fed. Reg. 49360-49361 (October 22, 1975) (emphasis added).

The Commission explicitly invited public comment on the effects of a temporary or permanent prohibition of commodity option transactions; particularly whether there were legitimate enterprises offering commodity options which would suffer substantial adverse effects from the ban or whether they could, without serious detriment, easily divert resources presently devoted to option transactions to other profitable opportunities. Id.

[25/] Among other things, the Commission urged comment on

> "1. What useful economic functions are performed by commodity option trading? In what ways do existing offerings of commodity options perform these economic functions?
>
> 2. Could option trading have an adverse economic effect upon futures trading in terms of liquidity or otherwise? If so, do these economic effects differ with respect to agricultural as contrasted with non-agricultural commodities?"

Id. at 49361.

case at bar, asked members of the public to respond specifically to the following questions, among others:

> "3. If option trading should be permitted, what form of regulation would be most appropriate and what specific rule should be adopted further to protect against fraudulent acts and practices and to provide financial safeguards to the customers of persons who are offering and selling options?
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> . . . .
>
> . . . .
>
> 6. What consideration should be weighed in determining whether option trading should be restricted to contract markets? If it is believed that option trading should be permitted otherwise than through the facilities of contract markets, what form of regulation would be appropriate?
>
> 7. What additional considerations, if any, would be relevant to whether or in what manner trading should be permitted in foreign commodity options, including the so-called 'London' option?"

40 Fed. Reg. at 49361-49362 (October 22, 1975) (emphasis added).

After consideration of the various comment letters received on the regulatory proposals it had announced,[26/] the Commission on February 20, 1976, proposed the adoption of comprehensive regulations governing off-exchange commodity option transactions. 41 Fed. Reg. 7774

[26/] Although plaintiff British American commenced business operation in October 1975 (see CFTC v. British American Commodity Options Corp., CCH Comm. Fut. L. Rep. ¶20,224 n. 12 (October 20, 1976), it tendered no written submission in response to the Commission's October 22, 1975 release. Copies of all comment letters received by the Commission in response to this and subsequent releases are being submitted to the Court in support of the Commission's motion.

(February 20, 1976).[27]

Those proposed regulations contained registration, recordkeeping and minimum financial requirements as well as a provision designed to effect disclosure of pertinent information to option customers. Among other things, the proposals would have made it unlawful for any commodity option dealer to offer or sell any commodity option unless the dealer (1) had total assets in excess of total liabilities and maintained a net-working capital in excess of $100,000; and

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[27] In announcing its proposal, the Commission stated that it

> ". . . expects to receive recommendations [on option trading] from its Advisory Committee . . . by no later than March 30, 1976. After the Commission has had an opportunity initially to evaluate those recommendations and the oral and written comments it receives on the proposed rules, the Commission will determine whether it will require additional time to study the recommendations and comments in order to evaluate the extent to which they should be included as part of a permanent regulatory program. If the Commission believes that such additional time is required, the proposed rules may be adopted as interim and temporary rules only. Commentators should also be aware that although the proposed regulations relate to transactions which are not entered into on a contract market, the Commission is affirmatively considering permitting commodity option transactions to be traded on or subject to the rules of a contract market which have been approved by the Commission as adequate to effectuate the purposes of the Act. The Commission would particularly welcome comments on what standards (differing from or similar to those proposed) should be applied if such transactions are so traded under the protections of a clearing association of a contract market. . . . Ultimately, the Commission may adopt regulations which restrict commodity option transactions to trading on contract markets."

41 Fed. Reg. 7774 (February 20, 1976).

This *Federal Register* notice is attached hereto as Exhibit E.

(2) was registered as a commodity option dealer with the Commission. The proposals also would have required an option dealer, in connection with offers to enter into commodity option transactions, to inform each prospective purchaser that the dealer had filed an application in connection with its registration with the Commission containing detailed information about the dealer, the dealer's business operations, its financial condition, the options offered and the charges incurred, and that copies of such filings were available for public inspection at all offices of the dealer and at the Commission's offices in Washington, D.C. 41 Fed. Reg. 7774, 7780 (February 20, 1976).

Although these proposed regulations did not include provisions for the segregation of customer funds or delivery of a disc[illegible]ure statement to prospective option purchasers, these matters were expressly addressed in the Commission's release and public comment on the merits of such requirements was expressly solicited.

> "With respect to segregation of premiums, while the Commission has determined not to impose such a requirement on commodity option dealers . . . , it is particularly interested in receiving comments as to whether such a requirement should and could be imposed. With respect to delivery in advance of disclosure statements to prospective purchasers, . . . the Commission is also interested in the views of interested persons as to whether such a requirement should be imposed."28/

In addition to the public comment period for written submissions with respect to the proposed rules, which extended through March 31, 1976, the Commission, although not required to do so, announced that it would hold an oral hearing on March 8 and 9, 1976, to permit

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28/ 41 Fed. Reg. 7774, 7776 (February 20, 1976).

further presentations on the matter and obtain the broadest possible public participation in the rulemaking process. At the oral hearing on March 8, various witnesses, including counsel for plaintiff British American, appeared and presented their views on the proposed regulations.[29]

On July 6, 1976, the Advisory Committee transmitted its report on commodity option trading to the Commission.[30] The report identified three broad categories of option trading that might occur in the United States: (1) trading in options through the facilities of contract markets designated by the Commission;[31] (2) trading in "domestic dealer options," i.e., domestic options issued and offered otherwise than through the facilities of a designated contract market; and (3) trading in "foreign options,"[32] whether or not originating on an organized foreign commodity exchange. The Advisory Committee also recognized that each of these categories might be subdivided into trading in

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[29] Certified copies of the transcript of the March 8, 1976 hearing and written presentations which were submitted in connection with that hearing and the comments received on the February 20, 1976 rule proposal are being submitted to this Court in support of the Commission's motion.

[30] A certified copy of the Advisory Committee Report is being submitted in support of the Commission's motion.

[31] At present, no commodity option trading takes place on designated contract markets.

[32] Foreign options currently traded in the United States include those sold on or through a member of one of the London commodity markets and cleared through the International Commodity Clearing House in London, and those issued by or through an individual member of the London Metals Exchange. Advisory Committee Report at p. x.

"assignable" and "non-assignable" options,[33/] into trading in "transferable" and "non-transferable" options,[34/] and into options on futures contracts and options on the actual commodities themselves.

After over seven months of analysis of these various forms of option trading, the Advisory Committee recommended that, with limited exceptions, no form of option trading should be prohibited, provided that a showing could be made, to the satisfaction of the Commission, with respect to each category of option trading, that certain basic customer protections available to participants in the futures markets, or their equivalents, could be provided to option customers. These essential protections concerned (1) segregation of funds; (2) a mechanism guaranteeing performance of the transaction; and (3) adequate supervision and control of trading practices and activities.[35/]

The Advisory Committee found that contract markets provided these protections and therefore there would be no reason to prohibit options transactions effectuated through contract market facilities. Accordingly, the Advisory Committee recommended that option trading on contract markets should be allowed and should be regulated in a fashion similar to futures trading on contract markets.[36/]

[33/] An "assignable" option is an option capable of being conveyed to a third party in a secondary market. A "non-assignable" option may not be so conveyed. Advisory Committee Report at p. ix.

[34/] A "transferable" option is capable of being liquidated by an equal and offsetting transaction. A "non-transferable" option may not be offset and can be liquidated only through exercise or lapse. *Id.*

[35/] *Id.* at 16.

[36/] *Id.* at 29.

The Advisory Committee further recommended that persons wishing to deal in domestic dealer options and foreign options should establish a system by which those options could be offered in the United States under circumstances providing safeguards substantially equivalent to those afforded futures customers on designated contract markets. The Advisory Committee also recommended that if any such system were submitted to, and approved by, the Commission, it should require option dealers to register with the Commission, to maintain minimum working capital and net worth, to "mark to the market" daily customers' open options positions, to physically segregate customer moneys and property and unrealized net equity in customer accounts, and to furnish a basic disclosure statement to prospective purchasers, containing, among other things, a description of mark-ups, charges and commissions and pertinent information concerning the particular option involved.[37]

After consideration of the public comments received on its prior proposals, the presentations made at its oral hearing on March 8, 1976, and the report and recommendations of its Advisory Committee, the Commission published proposed interim option regulations on October 8, 1976.[38] 41 Fed. Reg. 44560, 44566-68 (October 8, 1976). These proposed interim regulations were announced by the Commission as the first stage of a two-step procedure to adopt comprehensive regulations for a limited, rigidly-controlled, three-year pilot program that would ultimately restrict commodity option transactions to domestic boards of trade and foreign commodities exchange systems which satisfied stringent regulatory requirements. 41 Fed. Reg. 44560 (October 8, 1976). Through that test program, the Commission expected to obtain sufficient data involving the impact of commodity options trading on underlying futures and cash markets, the economic utility of such options trading, and the capabilities of exchanges to conduct adequate market surveillance and assure orderly markets in options, upon which to base a permanent regulatory program for commodity option transactions or, if necessary, to determine to ban options trading altogether. Id.

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[37] The record of the Advisory Committee's deliberations and other supporting documentation underlying its recommendations are contained in several appendices to its report, consisting of several thousand pages. It was not possible to duplicate this material in time to permit its filing with the Commission's motion. These appendices will, however, be made available to the Court and opposing counsel prior to the hearing scheduled for December 10, 1976.

[38] The Federal Register notice containing the Commission's proposal is attached hereto as Exhibit F.

The Commission stated that the interim regulations were designed to provide minimal customer protections in the offer and sale of commodity options which, until the second stage of the regulations could be implemented, would be allowed to continue to be conducted otherwise than through the facilities of organized exchange systems. The Commission explained that the registration, financial, segregation, and disclosure requirements contained in the proposals had been designed to effectuate the customer protection objective and to permit a gradual phase-in of the test program restricting option trading to designated domestic contract markets and Commission-recognized foreign commodities exchange systems. The Commission expressed its intention to adopt and make effective the proposed interim regulations on November 22, 1976. 41 Fed. Reg. 44560 (October 8, 1976). Although an effective date had been indicated, interested persons were nevertheless invited to submit written comments on the proposed rules to the Commission prior to November 8, 1976. Id. at 44568.

Following consideration of all the comments received, including those submitted by counsel for British American, the Commission adopted the interim regulations substantially in the form previously proposed. 41 Fed. Reg. 51808 (November 24, 1976). In view of certain revisions which the Commission deemed necessary as a result of the comments received, the effective dates of certain provisions were deferred for 15 days, except in the case of the segregation requirements which were deferred for 30 days. Id. Specifically, citing Sections 4c(b) and 8a(5) of the Act as providing it with broad statutory authority to promulgate these regulations, the Commission emphasized that its principal concern with respect to the regulation of commodity option transactions was to provide essential protections to commodity options customers. Id. at 51809.

As adopted, the regulations generally (1) make it unlawful on and after January 17, 1977, for any person to accept money or property from an option customer as payment of the purchase price of a commodity option unless such person is registered with the Commission as a futures commission merchant (§32.3, id. at 51814); (2) require individuals soliciting or accepting orders for commodity option transactions or supervising any person so engaged to register with the Commission as an associated person of a specified futures commission merchant by January 17, 1977 (§32.3, id. at 51814); (3) provide that registered futures commission merchants engaged in commodity option transactions maintain a minimum adjusted working capital of $50,000 or an amount computed on the basis of a percentage of aggregate indebtedness and a percentage of unrealized values of futures contracts with respect to both proprietary and customers' accounts (§1.17, id.); and (4) require persons engaged in the offer and sale of commodity options to segregate in a separate account in the United States the money or property accepted from an option customer as payment of the purchase price of a commodity option, except to the extent of 10 percent of the purchase price, until expiration of the term of the option or, if the option is exercised, until all rights of the option customer under the option have been fulfilled (§32.6, id. at 51815-51816). The regulations also require that persons engaged in the offer and sale of commodity options provide prospective option customers with a summary disclosure statement setting forth general information relating to the option being offered, including a listing of the elements comprising the purchase price to be charged and a general description of all other costs incurred, and that any person, as part of the written confirmation of the execution of a transaction, furnish the option customer with particularized price information regarding the option within 24 hours after execution. §32.5, 41 Fed.

Reg. 51808, 51815 (November 24, 1976). Furthermore, §32.7 of the regulations requires each person engaged in the offer and sale of commodity options to maintain pertinent books and records, as therein specified, relating to the solicitation and the accounts of option customers. Id. at 51816. While recognizing that the financial, segregation and other requirements imposed by the regulations upon persons wishing to engage in the commodity options business were viewed by some commentators as anticompetitive in some respects, the Commission indicated that it had considered the public interest to be protected by the antitrust laws and had determined that the regulations in the form adopted were in accord with the requirements of Section 15 of the Act, 7 U.S.C. §19 (Supp. V, 1975) i.e., that the Commission endeavor to take the least anticompetitive means of achieving the Act's purposes.

In the Federal Register notice publishing the regulations, the Commission determined that, with the exception of §32.6 relating to the segregation of premiums, all other provisions of the regulations would become effective 15 days after publication--i.e., on December 9, 1976. The Commission affirmatively found that the public interest required that the rules be adopted without any further delay "inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which has historically been fraught with abuse." Id. at 51817. The Commission further pointed out, as is evident from the preceding text, that "affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by" the specified effective dates. Id.

ARGUMENT

The record of the Commission's consideration of the commodity options rules, which the plaintiffs attack, demonstrates a careful evaluation by the agency of a unique and complex business activity. The rulemaking proceeding necessarily required choices to be made between competing considerations with a view to the development of a comprehensive regulatory scheme consistent with the public interest, which Congress plainly intended the Commission to accomplish.

In the course of the proceeding, the Commission has far exceeded the minimum standard applicable to agency rulemaking under the Administrative Procedure Act--particularly those of its provisions requiring meaningful public participation in the rulemaking process. Furthermore, in addition to the consideration of these matters by members of the Commission staff, the Commission appointed an Advisory Committee of distinguished persons, knowledgeable with respect to the commodities industry, to aid in the Commission's analysis and to recommend appropriate action. As the public record of its proceedings demonstrates, the Commission has carefully weighed all competing considerations and has fully articulated its conclusion concerning each and every significant factor that was brought to its attention during the many months of deliberations. Moreover, the plaintiffs have in fact meaningfully participated in the rulemaking proceeding; plaintiff's counsel appeared and testified at a public hearing held in March 1976, and British American offered written comments to the Advisory Committee to aid in its deliberations and commented directly to the Commission upon the form of rules finally proposed by the Commission on October 8, 1976.

Plaintiffs, however, are not pleased with the fact that the Commission has viewed the question of commodity option regulation differently than they had proposed. Thus, plaintiffs come before this court seeking, essentially, to have their views substituted for those of the Commission on these important questions of public policy.

To the extent that the plaintiffs present matters of substance, the Commission has fully addressed their contentions in response to Commission comments received during the course of the rulemaking proceeding. Nevertheless, the more significant of these issues are discussed below. To the extent that procedural objections are presented, as we will show, plaintiffs' contentions are wholly baseless.

I. THE OPTIONS REGULATIONS PROMULGATED BY THE COMMISSION WERE WELL WITHIN ITS STATUTORY AUTHORITY. THE COMMISSION CANNOT BE ESTOPPED FROM EXERCISING ITS QUASI-LEGISLATIVE POWERS UNDER THE ACT.

Section 4c(b) expressly provides that the Commission may prohibit any option transaction or allow "any such transaction under such terms and conditions as the Commission shall prescribe." Thus, the plain language of that section imposes no limitations upon the substance or form of regulations which the Commission can adopt with respect to commodity option transactions. And, as we have shown, the legislative history of the Act clearly confirms that the Commission's power under Section 4c(b) was intended to be pervasive.

Nevertheless, plaintiffs seem to imply (Memorandum pp. 19-20)[39a/] that the Commission's authority to regulate commodity options has somehow evaporated for no other reason than that the 1974 amendments to the Commodity Exchange Act have "been on the books for 2-1/2 years and during this period, the Commission has permitted persons to engage in this business."[39b/] But the authority of an agency does not atrophy merely because it has not been used. Cf. Securities and Exchange Commission v. Morgan, Lewis & Bockius, 209 F. 2d 44, 49 (3d Cir. 1953). This is clearly not a situation where any inference may be drawn that authority does not exist based upon an agency's long-standing failure

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[39a/] "Memorandum p. ___" refers to pages of plaintiff's Memorandum of Law in Support of a Temporary Restraining Order and/or Preliminary Injunction dated November 22, 1976.

[39b/] In this way British American misleadingly implies that the Commission has not acted for 2 1/2 years. While the 1974 amendments to the Commodity Exchange Act were approved by President Ford on October 23, 1974, the Commission did not come into existence until April 21, 1975, and did not have authority even to begin consideration of option regulation until that date. See, Note entitled "Effective Date of 1974 Amendments" following 7 U.S.C. § 2 (Supp. V, 1975).

to act; in fact, section 4c(b)'s express language would imply the opposite. Moreover, the time span prior to the adoption of these interim regulations should not be raised to question the Commission's authority and responsibility; rather it forcefully indicates the Commission's appreciation of the complexities of the problems and its desire to assure full and proper consideration before action was taken.^{40/}

Neither is the Commission somehow estopped from regulating plaintiffs' business merely because the plaintiffs have been dealing in commodity options prior to the issuance of the regulations as plaintiffs seem to

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40/ Section 4c(b) states that the Commission shall adopt regulations governing commodity option transactions

> ". . .within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time . . . ." 7 U.S.C. §6c(b) (Supp. V, 1975) (emphasis added).

The Senate version of the 1974 amendments originally required, without qualification, that the Commission promulgate rules governing commodity option transactions within one year after the effective date of the amendments. S. Rep. No. 93-1131, 93d Cong., 2d Sess. 26 (1974). The Conference Committee recognized, however, that the issuance of such regulations might reasonably take a longer period of time. Thus, the final legislation provided that the Commission should notify the Committees charged with oversight of the Commission's activities, if the Commission should be unable to issue regulations governing options transactions within a year. S. No. 93-1194, 93d Cong., 2d Sess., 40 (1974).

In accordance with this provision, on April 21, 1976, the Commission informed the Chairmen of the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that, because of the complexity of issues involved in the regulation of commodity option transactions, the Commission had determined that it would be necessary to spend additional time to deliberate on all issues and establish a comprehensive regulatory scheme covering such option transactions. The Commission also stated that it was awaiting the report of its Advisory Committee on the Definition and Regulation of Market Instruments, chaired by Commission Vice-Chairman John V. Rainbolt II. 41 Fed. Reg. 16685 (April 21, 1976.)

suggest (Memorandum of Law, p. 19). The Commission cannot, through its acts or omissions, waive the requirements of a statutory provision; nor can a doctrine of estoppel be asserted to prevent the Commission from doing its clear statutory duty. Securities and Exchange Commission v. Culpepper, 270 F.2d 241, 248 (2d Cir. 1959); Mines and Metals Corp. v. Securities and Exchange Commission, 200 F.2d 317, 320-321 (9th Cir. 1952), cert. denied, 345 U.S. 941 (1953). The public interest should not be prejudiced by the negligence of public officers--even were it possible, arguendo, to suggest that the Commission was somehow negligent in seeking to assure complete consideration and avoid acting with undue haste. See United States v. 93 Court Corporation, 350 F.2d 386, 388 (2d Cir. 1965), citing United States v. Nashville C. & S. L. Ry., 118 U.S. 120 (1886).

Furthermore, neither of the plaintiffs were offering options to the public prior to the 1974 amendments to the Commodity Exchange Act; and since those amendments were adopted, all persons, including the plaintiffs, have been on notice that the Commission's authority goes so far that it could, if it chose to do so, ban option transactions. From its inception, the Commission has publicly recognized its obligation to determine whether and how to regulate commodity option transactions.[41/] On April 25, 1975, only four days after the Commission came into existence, the Commission proposed an antifraud rule governing commodity option transactions, a final form of which became effective on June 24, 1975 (40 Fed. Reg. 26505).

[41/] 40 Fed. Reg. 18187 (April 25, 1975), which it adopted shortly thereafter. See Rule 30.01: Fraud in Connection with Commodity Options. 40 Fed. Reg. 26504 (June 24, 1975).

In October 1975—literally within a few days of the date upon which British American commenced operation--the Commission solicited the views of knowledgeable persons concerning which of several regulatory approaches the Commission should adopt. The Commission specifically inquired

> ". . . what form of regulation would be most appropriate and what specific rules should be adopted further to protect against fraudulent acts and practices and to provide financial safeguards to the customers of persons who are offering and selling options?" [42]

Again, in February 1976, the Commission published proposed rules for the regulation of commodity option transactions.[43] While that proposal, if adopted, would not have required commodity option dealers to segregate premiums received for commodity options or to deliver disclosure statements, the Commission did expressly solicit comments as to whether a requirement for premium segregation and disclosure requirements should be imposed.[44]

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[42] 40 Fed. Reg. 49360, 49361-49362 (October 22, 1975). Among the several comment letters that the Commission received in response, five commentators recommended segregation as a means of protecting commodity option customers' funds.

In the same release the Commission expressed its views that persons who were dealing with commodity options should be registered as commodity trading advisors. 40 Fed. Reg. at 49361 n. 11 (October 22, 1975). Plaintiff British American did not apply for registration until March, 1976, and, to date, that application has not been granted. In fact, the Commission is presently conducting a proceeding to determine whether the application should be denied.

Plaintiff Lloyd Carr & Co. has not applied for registration although a predecessor firm did apply for registration in September.

[43] 41 Fed. Reg. 7774 (February 20, 1976).

[44] 41 Fed. Reg. 7774, 7776 (February 20, 1976).

In July 1976--the same month in which plaintiff Lloyd, Carr & Co. (or its predecessor) commenced operation (Affidavit of James Carr)--the Advisory Committee's report to the Commission recommended full segregation of customer funds, minimum financial requirements for persons selling options, and disclosure statements for customers, and did so after numerous public hearings and meetings at which these issues were fully explored.[45] Significantly, while the plaintiffs would have the Court believe that the Commission's regulatory scheme came as a surprise to them, they were aware of the Commission's deliberations and, moreover, participated in the hearings before the Commission which led to the promulgation of the rules. See testimony of Counsel for British American pp. 131-182 of the transcript of March 8, 1976, hearing.

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[45] Recommended Policies on Commodity Option Transactions, CCH Comm. Fut. L. Rep., Special Edition No. 26, pp. 30-31, 33 (July 15, 1976).

II. THE COMMISSION FULFILLED ITS OBLIGATIONS UNDER SECTION 15 OF THE ACT.

In promulgating any rule, the Commission is required by Section 15 to:

> ". . . take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of *achieving the objectives of [the Commodity Exchange Act], as well as the policies and purposes of [the Commodity Exchange Act]* . . . ." 7 U.S.C. §19 (Supp. V, 1975) (emphasis added).

This does not mean, however, that the Commission can never take action which may have an anticompetitive effect. Rather, as the Conference Committee which reported on the amendments to the Commodity Exchange Act stated, Section 15 is merely a requirement that the Commission "*endeavor* to take the least anticompetitive means of achieving the objectives of the Commodity Exchange Act . . . ."[46/] Contrary to the manner in which the plaintiffs would have this Court interpret its provisions, Section 15 was:

> ". . . not intended to constitute any procedural roadblock to the Commission in regulating the futures trading industry, . . . separate proceedings to consider

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[46/] S. Rep. No. 93-1194, 93d Cong., 2d Sess. 35 (1974)(emphasis added).

> antitrust and anticompetitive matters are not required by the Commission in . . . adopting any Commission rule or regulation . . . ." 47/

Section 15 does not require the Commission to promote unfettered competition. Thus, for example, if the Commission should be confronted with several regulatory alternatives, one of which seems effective to achieve a statutory goal, but would have a greater anticompetitive effect than the others, the Commission is not prevented from adopting that approach. 48/ Indeed, the language of Section 15 makes clear that to save the objective of the Commodity Exchange Act must always be the paramount consideration.

Plaintiffs attack the option regulations as having been adopted in violation of Section 15 and as being anticompetitive in violation of the antitrust laws. In particular, they challenge as anticompetitive the Commission's disclosure requirements because similar requirements--and the attendant expenses--are not imposed on persons dealing in commodity futures contracts. They suggest that the Commission's antifraud rule alone would be sufficient to achieve the statutory purposes and, accordingly, would be the least anticompetitive means of achieving those purposes.

But the Commission has determined that more than its antifraud rule is necessary to achieve the customer protection objectives of

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47/ S. Rep. No. 93-1194, 93d Cong., 2d Sess. 35 (1974).

48/ The courts have long recognized that repeal of the antitrust laws may be implied to permit a regulatory scheme to operate. *Gordon* v. *New York Stock Exchange*, 422 U.S. 659 (1975); *United States* v. *National Association of Securities Dealers*, 422 U.S. 694 (1975); *Silver* v. *New York Stock Exchange*, 373 U.S. 341, at 357 (1963); *United States* v. *Interstate Commerce Commission*, (Northern Lines Merger Cases), 396 U.S. 491, 511-515 (1970), *citing County of Marin* v. *United States*, 356 U.S. 412, 416-418 (1958); *Pan American World Airways, Inc.* v. *United States*, 371 U.S. 296, 301, 309-310 (1963).

the Act and plaintiffs have no right to have their view substituted for the Commission concerning this issue.[49] Even when the Antitrust Division of the Department of Justice seeks to impose its view of relevant anticompetitive

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49/ Comment letters on the proposed rules raised similar objections to that now being raised by plaintiffs. The Commission considered those comments in adopting the regulations and addressed those comments in the release accompanying those rules:

> "Many of the persons who commented on the Commission's proposal of October 8, 1976, maintained that the Commission's proposal was anti-competitive in various respects: that it imposed stricter standards on persons dealing in commodity options than are presently imposed on persons dealing in commodity futures contracts; that it discriminated unfairly between futures commission merchants dealing in commodity options and futures commission merchants dealing in commodity futures contracts; and that it required disclosures to prospective option customers that are not required to be made to prospective customers dealing in commodity futures contracts. In proposing and in adopting the interim rules, the Commission has taken into account its responsibilities under Section 15 of the Act, 7 U.S.C. §19 (Supp. V, 1975), and has determined that the options regulations in the form proposed and as adopted meet the requirements of that Section. . . . While the Commission is mindful that the financial, segregation and other criteria imposed as prerequisites to allowing a person to enter into or continue in the commodity options business may result in some lessening of competition, in its judgment, the interim rules are necessary to effectuate an essential purpose and policy of the Act: That is to require that the Commission provide essential customer protections which would attempt to assure the financial solvency of option transactions and prevent fraud. As a result, rules have been adopted, particularly in the areas of registration, disclosure, segregation and minimum working capital, which are intended to provide such customer protections as are deemed essential. Such rules may have an anticompetitive effect in that not all persons will be able to comply because of lack of adequate financing or other reasons. Nonetheless, in weighing its responsibilities, the Commission has determined that the objectives, policies and purposes of the Act can be met, in its judgment, only by regulations such as these."

41 Fed. Reg. 51808, 51809 (November 24, 1976).

considerations upon an independent regulatory agency, the Supreme Court has recognized that the responsibility for weighing this factor along with other relevent considerations is for the agency alone. As stated in Northern Lines Merger Cases, supra, 396 U.S. at 513-514 (1970):

> "The Department [of Justice] urges that the [Interstate Commerce] Commission failed to give sufficient weight to the diminution of competition between the Northern Lines--in short, that it failed to strike the correct balance between antitrust objectives and the overall transportation needs that concern Congress. This contention tends to isolate individual factors that are to enter into the Commission's decision and view them as controlling considerations. 'Competition is merely one consideration here' . . . . Striking the balance is for the Commission, and we cannot say it did so improperly."

Thus, the plain facts are that the Commission adequately considered the anticompetitive factors cited by plaintiffs and made its determination based on its evaluation of all issues before it. The Court should not be asked to substitute its judgment for that of the Commission. Congress placed responsibility for such determinations in the hands of the Commission and, based upon its expertise in the field, it has exercised its responsibilities in a sound and judicious manner.

III. THE OPTION RULES THE COMMISSION HAS PROMULGATED ARE REASONABLE AND WERE ADOPTED IN ACCORDANCE WITH LAW

The regulations governing commodity option transactions which were published in the Federal Register on November 24, 1976,[50/] reflect the Commission's considered judgment as to the appropriate method of regulating commodity option transactions. The Commission's determination was made after extensive study of the offer and sale of commodity options in the United States, a process which has consumed substantial Commission resources and has involved broad public participation.[51/]

Nonetheless, plaintiffs suggest in their Amended Complaint (pp. 3-10) that the Commission's adoption of regulations governing commodity option transactions was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." See 5 U.S.C. §706(2)(A) (1970). It has been recognized, however, that:

> "[r]ule makers, as the delegatees of legislative power, are no more likely than their delegators to make everybody happy with a particular exercise of that power. [The court's] . . . function is to see only that the result is reasonable and within the range of authority conveyed, that it has been formulated in the manner prescribed, and that the disappointed have

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[50/] 41 Fed. Reg. 51808 (November 24, 1976).

[51/] See 40 Fed. Reg. 18187 (April 25, 1975); 40 Fed. Reg. 49360 (October 22, 1975); 41 Fed. Reg. 7774 (February 20, 1976); 41 Fed. Reg. 44560 (October 8, 1976); Report of the Advisory Committee on the Definition of Market Instruments, (July 15, 1976).

> had the opportunity provided by Congress to try to make their views prevail."

Automotive Parts & Accessories Association, Inc. v. *Boyd*, 407 F.2d 330, 343 (D.C. Cir. 1968). Thus,

> ". . . the court must consider whether the [Commission's] decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. . . . Although this inquiry into the facts is to be searching and careful, the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency." [52]

Accordingly, for a court to set aside administrative action as arbitrary and capricious, the party challenging the action must prove that it was "willful and unreasoning action, without consideration and in disregard of the facts or circumstances of the case . . . ."[53]

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[52] *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 416 (1971) (citations omitted). *See also*, *Wong Wing Hang* v. *Immigration and Naturalization Service*, 360 F.2d 715, 718 (2d Cir. 1966); *In Re Josephson*, 218 F.2d 174, 182 (1st Cir. 1954), both cited with approval in *Citizens to Preserve Overton Park Inc.* v. *Volpe*, *supra* at 416. *Accord*, *Bowman Transportation, Inc.* v. *Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 284 (1974); *Nader* v. *Sawhill*, 514 F.2d 1064, 1067 (Tem. Emer. Cir. 1975); *Environmental Defense Fund, Inc.* v. *Corps of Engineers of the United States Army*, 470 F.2d 289, 300 (8th Cir. 1972); *Rockbridge* v. *Lincoln*, 449 F.2d 567, 572 (9th Cir. 1971).

[53] *First National Bank of Fayetteville* v. *Smith*, 508 F.2d 1371, 1376 (8th Cir. 1974), *cert. denied*, 421 U.S. 930 (1975).

If a regulatory agency has articulated a rational connection between the facts found and the choices made, a reviewing court should "uphold a decision of less than ideal clarity if the agency's path may be reasonably discerned." *Bowman Transportation, Inc.* v. *Arkansas-Best Freight Systems, Inc.*, *supra*, 419 U.S. at 284. *See also*, *Burlington Truck Lines, Inc.* v. *United States*, 371 U.S. 156, 168 (1962).

As we have seen, the Commission has determined to implement a two-staged program for a rigidly controlled three-year (or shorter) pilot program designed to afford customer protection while at the same time enabling the Commission to obtain sufficient data on which to base a permanent regulatory program or, if necessary, to determine to prohibit commodity option trading in the United States. The regulations published on November 24 are merely the first step in this two-staged procedure and are designed to afford only minimum customer safeguards until such time as the Commission implements the second stage.

The provisions that plaintiffs challenge are precisely those that will provide the safeguards the Commission has determined to be essential to provide adequate customer protection: making it unlawful for any person to accept money from an option customer without registration as a futures commission merchant (§32.3); imposing minimum financial requirements on registered futures commission merchants who will deal in options (amended §1.17); requiring adequate disclosure to option customers (§32.5); requiring segregation of the purchase price paid by an option customer (§32.6); and requiring certain books and records to be maintained by persons soliciting and accepting orders for commodity options (§32.7).[54]

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[54] The Commission has also provided in section 32.4(b) that it will consider requests for exemptions from these, as well as other requirements of the regulations, although an exemption will be granted only if it is in the public interest. 41 Fed. Reg. at 51812. Plaintiffs challenge to this exemptive provision will be discussed *infra* at page 41-43.

A. Minimum financial requirement

The interim rules adopted by the Commission include amendments to regulation 1.17, which require futures commission merchants to have and to maintain a minimum adjusted working capital equal to, or in excess of, the greater of (1) a fixed dollar amount or (2) a "safety factor" computation based upon a percentage of the market value of open futures contract positions,[55/] if any, plus 5% of the firm's aggregate indebtedness.[56/] For futures commission merchants engaged in options activity, the fixed dollar amount will be $50,000 under the option rules, as compared to $10,000 for other futures commission merchants. The higher amount is necessary, in the Commission's view, to protect customers from various possible contingencies, such as the bankruptcy of the option vendor, which might arise in connection with option activities. In contrast, futures commission merchants who deal exclusively in futures contracts segregate customer funds and by marking to the market daily are monitored by the clearing association of the contract market. Thus, as a result of built-in safeguards, financial problems affecting such entities are less susceptible to high customer losses.

Plaintiffs have not challenged the Commission's determination to impose minimum financial requirements, or, indeed, to apply a $50,000

[55/] The utilized percentage of the market value of open futures contract positions is referred to in the rule as a "safety factor." See sections 1.17(d), (e), 17 C.F.R. §1.17(d), (e) (1976).

[56/] Aggregate indebtedness is basically that portion of the total liabilities (with certain exceptions) which are not adequately collateralized, that is, not secured by identified assets pursuant to a written instrument. See section 1.17(c)(7), 17 C.F.R. §1.17(c)(7) (1976).

minimum capital requirement to persons dealing in options. They have instead challenged that portion of the Commission's regulation which may impose a greater net capital requirement upon a particular firm based upon the safety-factors-plus-aggregate-indebtedness computation. But plaintiffs have plainly misunderstood the regulation.

Exhibit C to the Amended Complaint demonstrates that in their haste to seek judicial relief, plaintiffs have misconstrued the manner in which the minimum financial requirement is to be computed under section 1.17 of the regulations. Contrary to plaintiffs' assertions, they will not be required, respectively, to raise $3,000,000 and $1,000,000 in capital. First, Exhibit C mistakenly includes futures contracts underlying unexercised options--contracts that have not yet been acquired--in the computation of the safety factor.

Secondly, plaintiffs are correct in using a safety factor of 10% of open futures contracts in the firm's accounts.[57/] However, if plaintiffs were registered futures commission merchants and were using the firm's futures contracts to close out customers' option positions, they would be assuming financial responsibility for the fulfillment of the commodity options in violation of section 1.19 of the Commission's regulations. See section E, *infra*. As futures commission merchants, they would be required to close the customers' option positions by purchasing, as brokers, futures contracts for customers' accounts, in which case a one-half of 1% safety factor would be appropriate,[58/] in lieu of a 10% safety factor, thereby making their present computation inaccurate.

[57/] Section 1.17(e); 17 C.F.R. §1.17 (1976).

[58/] Section 1.17(d); 17 C.F.R. §1.17(d) (1976).

Thirdly, plaintiffs have erroneously included the unrealized value of their customers' outstanding option positions in their computation of aggregate indebtedness.[59] Moreover, as we have noted, the minimum net capital requirement in section 1.17 is the greater of $50,000 or the sum of the safety factor plus 5% of the aggregate indebtedness. The two figures are not added, as has been done in Exhibit C; plaintiffs have misread "or" as "and".[60]

Plaintiffs also err in suggesting (Amended Complaint, p. 4) that regulation 1.17 exempts from the minimum financial requirements "purveyors of futures contracts" who are members of domestic exchanges".[61] It is true, of course, that regulation 1.17(b)(2) provides that the financial requirements of that section do not apply to members of a contract market that conform to minimum financial standards and related requirements that the contract market has established in rules approved by the Commission. But the rules of only two contract markets have been approved by the Commission, and neither imposes financial standards less stringent than those contained in section 1.17.

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[59] For the same reason, the allegations in section 8(a)(ii) of the Amended Complaint regarding "conflicts of interest" are without foundation.

[60] In addition, in suggesting the risk of immediate injury (Amended Complaint, p. 5), plaintiffs assert that they will have to meet the minimum financial requirement by December 9, 1976. But, by their express terms, the minimum financial requirements of §1.17, as amended, apply only to persons who have applied for registration or are registered as futures commission merchants. More to the point, however, under section 32.3(a) of the rule, a person who accepts money from customers for option transactions need not be registered as futures commission merchants until January 17, 1977 (see 41 Fed. Reg. 51809 (November 24, 1976)). Thus, even if there were a demonstration of a judicially cognizable injury--which there has not been--there is no risk of an immediate harm to [illegible] extraordinary relief.

[61] Plaintiffs' related assertions in paragraph 8(a)(v) of the Amended Complaint that persons registered with the Securities and Exchange Commission who offer futures contracts are somehow exempt from regulation 1.17 are baseless.

Plaintiffs also contend (Amended Complaint, p. 4) that the minimum financial requirement in §1.17 is somehow inconsistent with the segregation requirement imposed by § 32.6. But the segregation provision is intended to supplement the obligations contained in § 1.17; accordingly, the fact that they impose additional requirements on the plaintiffs, which we readily concede, in no way suggests a conflict in the provisions.

The Commission has determined that minimum financial standards and segregation of premiums are both necessary to maintain the financial integrity of commodity option transactions and to afford an appropriate degree of customer protection. The segregation of 90% of the premium paid under §32.6 will ensure that an option customer would at least be able to recover a substantial portion of the price he has paid to purchase a commodity option in the event of the insolvency of the futures commission merchant. The minimum net capital requirements are intended to provide a further cushion for protection of such customers in the event of insolvency.

Section 1.17 additionally provides a minimum standard against which the Commission may measure the financial condition of a futures commission merchant to determine whether it may be in financial difficulty. If a futures commission merchant's position should become unstable, it might be tempted to convert the segregated funds of its customers to its own use. Congress recognized this in requiring that futures commission merchants may not be registered unless they meet minimum financial standards. See Section 4f(2) of the Act, 7 U.S.C. §6f(2) (1970). The Senate report accompanying the 1968 amendments of Section 4f(2), which authorized the agency to set such standards, explained that:

> "[T]he danger to the public from such financial irresponsibility is obvious. The underfinanced brokerage firms have been found to be most likely to dip into customers' funds or resort to sharp trading practices to bolster their money needs.
>
> Under the proposed amendment [of section 4f(2) of the Act], applicants for registration will be required to demonstrate reasonable capital resources . . . ." 62/

B. Segregation

Segregation by a futures commission merchant, within the United States, of 90% of the purchase price paid by a commodity option customer was found by the Commission to be essential to protect at least the basic investment of the customers as well as to assure, to some extent, the financial integrity of his option transaction. 63/

62/ S. Rep. No. 947, 90th Cong., 2d Sess. 1 (1968).

63/ 41 Fed. Reg. at 51812 (November 24, 1976).

In this way the Commission sought to alleviate, to some extent, a problem recognized by the Commission's Advisory Committee:

> "At the present time, neither United States nor London vendors of . . . [options cleared by the International Commodity Clearing House or vended through members of the London Metals Exchange] are required to segregate funds received from United States customers. Moreover, neither the ICCH nor the LME currently guarantees to United States customers the performance of obligations on any ICCH or LME option. The Advisory Committee has been informed that these and other circumstances, such as the absence of financial requirements for option dealers in the United States and the lack of regulation of the United States market for Foreign Options, make it very difficult for United States customers to obtain redress in the United States from dealers of 'London' options in the event of a default on the option transaction. On this basis, the Advisory Committee has determined that, to the extent possible, these deficiencies sould be remedied by the Commission." 64/

The proposed rules that the Commission published on October 8, 1976, would have required that 100% of the purchase price be segregated. 65/ The Commission, after considering comments on this proposal--including comments submitted by counsel for the plaintiffs--determined to reduce the segregation requirement to 90% to permit a futures commission merchants to utilize up to 10% of the purchase price it receives to defray

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64/ Advisory Committee Report at pp. 41-42.

65/ 41 Fed. Reg. 44560, 44567 (October 8, 1976).

operating expenses or the costs of any necessary financing arrangements.[66]

Plaintiffs argue, however, that the 90% requirement will create a "negative cash flow" of 342% (Memorandum, p. 3). Of course, plaintiffs greatly exaggerate the probable effect of the segregation requirement. The purchase price paid by commodity option customers will normally include not only the premium and fees which must be paid to the London broker who will purchase the option but also mark-ups, commissions and other fees imposed by the futures commission merchant. Thus, under the segregation rule, the futures commission merchant will be required to finance, in one way or another, only that portion of the purchase price that it must remit to the London broker to purchase the option. His costs, therefore, would normally be no more than the interest he may have to pay to borrow the funds he must currently remit to London, plus operating expenses associated with current option transactions. The cash needed for these purposes, however, will be offset in substantial measure, if not in full, by the interest accruing to the futures commission merchant on the full amount of funds received from the customer which he has segregated,[67] as well as by the 10% of the purchase price that the rule, as adopted, will permit the futures commission merchant to apply to current expenses.

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[66] 41 Fed. Reg. at 51812. On and after December 27, 1976, persons accepting funds from option customers as the purchase price for a commodity option are required to comply with the segregation requirements; on and after January 17, 1977, such persons are required to register with the Commission as futures commission merchants.

Even assuming that the segregation requirement may cause financial hardship to plaintiffs, the Commission weighed the possible burden upon futures commission merchants against the need for adequate customer protection when it proposed and adopted the segregation rule. It expressly requested from commentators the proposal of suitable alternatives that might afford substantially equivalent customer protections. Since no clearly viable alternatives were submitted, however, the Commission determined to adopt the segregation rule in order to assure minimal customer protections.[68]

Adversely affected firms may nevertheless seek exemption from the segregation requirements (or other requirements of the rules) pursuant to section 32.4(b). While a request seeking exemption from the segregation requirements would have to set forth an alternative to segregation which the requesting person will utilize in connection with its commodity option transactions,[69] the Commission delayed the effective date of section 32.6 until December 27, 1976, in order to provide additional time for any affected persons to effect compliance or request exemption.

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[67] Under the segregation rule, a futures commission merchant is permitted to deposit the segregated funds in a bank and/or in various obligations of the United States. Any interest accruing on such deposits or investments may inure to the benefit of the futures commission merchant.

[68] The Commission is nevertheless still willing to entertain any proposal submitted that would provide equivalent customer protections capable of prompt implementation. In fact, the Commission has indicated that it would especially welcome proposals that might provide for such alternatives as bonding, letters of credit or insurance.

Apparently, because they are unable or unwilling to provide segregation or a satisfactory alternative, plaintiffs claim that the exemption provision itself is arbitrary and capricious.[70] But section 32.4(b) will permit an exemption if the Commission should find that it would not be contrary to the public interest to grant an exemption. In arguing that the Commission must necessarily act arbitrarily in applying this standard, plaintiffs ignore that otherwise broad terms such as "public interest" take their meaning from the context in which they are found. See National Association for the Advancement of Colored People v. Federal Power Commission, - U.S. -, 96 S. Ct. 1806, 1811-1812 (1976). Thus the customer-protection objectives of the segregation rule will establish the standard against which the Commission must evaluate an application for exemption from its terms. And that standard can be applied by a reviewing court to determine whether the Commission's decision is reasonable and not arbitrary. Thus, even if it were assumed that the Commission might act arbitrarily under the regulation, that does not render the adoption of the regulation itself an arbitrary exercise of power--which is the sole issue before the court. Should plaintiffs be aggrieved by the Commission's future application of section 32.4(b), they may seek appropriate judicial relief at that time.

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[69] 41 Fed. Reg. at 51812 (November 24, 1976).

[70] Plaintiffs incorrectly state (Amended Complaint, pp. 7, 8) that the "staff" of the Commission will pass on requests for exemptions. Only the Commission may grant exemptions pursuant to section 32.4(b).

C. Disclosure

The Commission has found that a significant number of commodity options have been and are being sold through the use of high-pressure sales tactics to persons unfamiliar with the commodity markets generally, and with commodity options in particular. Even when disclosure has been made to option customers, it has often been inaccurate or misleading, either in content, presentation, or both.[71] For these reasons section 32.5 of the Commission's options regulations will require that a summary disclosure statement must be furnished by a futures commission merchant to a commodity option customer in advance of any option transaction so that the customer can

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[71] See 41 Fed. Reg. 44560, 44564 (October 8, 1976). See also Commodity Futures Trading Commission v. First Commodity Corp. of Boston, Civil No. 76-4051 [illegible] (D. Mass. 1976)(permanent injunction entered [illegible] 11, 1976); Commodity Futures Trading Commission v. Rosenthal [illegible] Civil Action No. 76 C 3904 (N.D. Ill., 1976) (consent to preliminary injunction entered November 8, 1976); Commodity Futures Trading Commission v. American Options Corp., No. 75-3555 (C.D. Calif. 1976); Commodity Futures Trading Commission v. J. S. Love & Associates Options, Ltd., Civil Action No. 76-923 (DBB)(S.D.N.Y. 1976) (consent decrees entered March 1, 1976); Commodity Futures Trading Commission v. American Overseas Trading Corp., C-75-1970A (N.D. Ga 1976) (permanent injunction entered October 15, 1976).

become familiar with certain aspects of commodity option transactions. The required disclosure document must set forth a brief description of the commodity option transaction being offered, the type of costs that may be incurred, certain elements of risk, and certain specified statements relating generally to commodity option transactions. In addition, upon execution of a commodity option transaction, the customer must receive a confirmation statement including particularized price information.

The Commission had originally proposed that a more particularized disclosure statement be provided to customers not less than 24 hours prior to the entry into each commodity option transaction. Commentators persuasively argued, however, that the 24 hour period was impractical because of the volatile nature of the commodities markets, and that delivery of a disclosure statement prior to each transaction was unduly burdensome. Commentators also reasonably suggested that the summary disclosure statement might be limited to generalized transaction information with particularized data furnished as part of the confirmation statement. The Commission modified its proposed regulations to meet these constructive suggestions.

Plaintiffs apparently misconstrue the disclosure rule as adopted. Contrary to their apparent belief (Amended Complaint, p. 5), the summary disclosure statement need not contain particularized price information if it is not then available. If such information is known prior to the transaction, the person soliciting or accepting the order need only inform the commodity option customer of that information. See section 32.5(c). If particularized price information is not known at that time, the commodity option customer need be provided only the generalized information contained in the summary disclosure statement.

Plaintiffs suggest (Amended Complaint, p. 6) that certain of the required disclosures will be "false and misleading and/or totally irrelevant." But the Commission has carefully considered each of the matters required to be included in the disclosure statement and has determined that each is reasonably necessary to enable a customer to obtain a basic understanding of commodity option transactions offered at the present time. Moreover, contrary to plaintiffs' claim (Amended Complaint, p. 6), the Commission cannot be said to have acted arbitrarily or capriciously in requiring affected persons generally to state the effect that foreign currency fluctuations might have on the commodity options they are offering, see section 32.5(a)(4); there is no requirement "to forecast" a particular currency fluctuation. Further, contrary to plaintiff's allegations (Amended Complaint, p. 6), the Commission's rules do not address the method of closing out options by buying or selling futures contracts, but require only that the option customer be informed generally that they will be unable to resell options in any market and may liquidate their options only by exercising them. See section 32.5(a)(6)(ii).[72]

D. Books and Recordkeeping

As part of the books and recordkeeping provisions of section 32.7, the Commission has required that persons retain and furnish the Commission upon request the true name and address of each commodity option customer or prospective customer solicited. This information will assist the Commission's monitoring of the activities of persons offering commodity option transactions to assure compliance with the interim rules. For example, this information will enable the Commission to canvass customers and prospective customers to ascertain what representations are made to them and whether the required disclosure statements have been provided to them.

While plaintiffs argue (Amended Complaint, p. 9) that they will be unable to verify the "true" names and addresses of customers and persons solicited, no such verification is necessary. The rule simply requires retention of accurate records of business activities and that they be provided to the Commission upon request. The Commission's interest is not whether an option customer has used an assumed name, but whether it will be able to contact the customers with whom the option dealer has dealt.

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[72] Plaintiffs allegations may refer to the language in proposed section 32.5(a)(5)(ii) that an alternative method of liquidating a position would be "by entering into an offsetting transaction." 41 Fed. Reg. at 44567 (October 8, 1976). This language was deleted from section 32.5(a)(6)(ii) as adopted, 41 Fed. Reg. at 51811, 51815 (November 24, 1976).

Plaintiffs also challenge the rule as arbitrary and capricious because the Commission has used but has failed to define the term "solicited." The fact that a term is not expressly defined in a regulation does not make the regulation arbitrary or capricious. Rather, it requires simply that the ordinary English meaning of the term be applied unless the context requires otherwise. Moreover, that particular term has been used by Congress in defining both "futures commission merchant"[73/] and "associated person"[74/] in the Commodity Exchange Act, as amended. Presumably, a comparable meaning will be appropriate under the option rule. In any event, if either plaintiff is uncertain as to how the term might be interpreted in a specific factual situation, that question concerns how the rule will be applied, not the validity or reasonableness of the regulation.

In addition, the Administrative Procedure Act provides an administrative remedy for such a situation. Section 5d of the Administrative Procedure Act, as codified, 5 U.S.C. §555(e) (1970), provides that an agency "with like effect in the case of other orders, and in its sound discretion, may issue a declaratory order to terminate a controversy or remove uncertainty." Even in the absence of a justiciable controversy, an administrative "remedy" would be available to the plaintiffs to seek clarification of this and other matters they have placed in issue. The Administrative Procedure Act [illegible]-

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73/ Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975).

74/ Section 4k(1) of the Act, 7 U.S.C. §6k(1) (Supp. V, 1975).

tees to the plaintiffs a right that may be pursued. It provides, 5 U.S.C. §555(b) (1970):

> "So far as the orderly conduct of public business permits, an interested person may appear before an agency . . . for the presentation, adjustment, or determination of any issue, request, or controversy . . . in connection with an agency function."

E. Registration

The Commission has provided in section 32.3(a) that it is unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an options customer as payment of the purchase price in connection with a commodity option transaction if that person is not registered with the Commission as a futures commission merchant under the Act. This requirement reflects a basic judgment of the Commission that options activities should be entrusted only to persons who meet the basic financial and other requirements of futures commission merchants under the Act and the regulations promulgated thereunder.

As plaintiffs point out, futures commission merchants are subject to the requirements of regulation 1.19.[75] That regulation provides that no futures commission merchant shall "make, underwrite, issue, or otherwise assume any financial responsibility for the fulfillment" of commodity option transactions. Regulation 1.19 does not, however, prohibit futures commission merchants accepting money from option customers in connection with option transactions if the futures commission merchant acts solely in an agency capacity.[76] Accordingly, plaintiffs' suggestion (Amended Complaint, p. 10) that the existence of regulation 1.19 precludes them from engaging in commodity business without violating that regulation is based on a misunderstanding of what that regulation forbids.[77] In any event the

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[75] 17 C.F.R. §1.19 (1976).

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[76] 41 Fed. Reg. 51813 (November 24, 1976).

[77] Regulation 1.19 was adopted by the Commission's predecessor agency, the Commodity Exchange Authority (of the Department of Agriculture), on October 5, 1973. 38 Fed. Reg. 28031 (October 11, 1973). Prior to the adoption of regulation 1.19, the administrator of the Commodity Exchange Authority testified before the House Subcommittee on Special Small Business Problems that the regulation was designed to:

> ". . . prohibit a registered futures commission merchant from issuing, underwriting, or otherwise assuming financial responsibility for 'puts' and 'calls.' By prohibiting this type of activity in which there is great financial risk, we will lessen the possibility of firms getting into financial difficulty and dipping into . . . commodity customers' funds to cover their losses. Under the proposed regulation, a registrant could continue to act as a broker on such transactions."

Hearings before the Subcommittee on Special Small Business Problems of the House Permanent Committee on Small Business, 93d Cong., 1st Sess. at 320 (1973)

In an explanatory press release following the adoption of regulation 1.19, the Department of Agriculture stated that, in adopting the regulation, it had "decided to restrict registered futures commission merchants to acting only as brokers when dealing in nonregulated commodity options." U.S. Department of Agriculture News Release No. 3173-73 (October 12, 1973).

Commission will consider repeal of regulation 1.19 in the second stage of its regulations when all such transactions will be limited to designated contract markets or Commission recognized foreign options systems. If repealed, futures commission merchants would then be permitted to issue, or otherwise assume financial responsibility for the fulfillment of, commodity option transactions.[78/]

78/ 41 Fed. Reg. at 44561 (October 8, 1976), 41 Fed. Reg. at 51813, 51814 (November 24, 1976).

IV. THE COMMISSION COMPLIED FULLY WITH THE REQUIREMENTS OF THE ADMINISTRATIVE PROCEDURE ACT, 5 U.S.C. §553, AND PROVIDED THE "NOTICE AND OPPORTUNITY FOR HEARING" REQUIRED BY SECTION 4c(b) OF THE COMMODITY EXCHANGE ACT, AS AMENDED.

Section 4 of the Administrative Procedure Act, as codified, 5 U.S.C. §553, requires that:

> "(b) [g]eneral notice of proposed rule making shall be published in the Federal Register . . . . The notice shall include--
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> (1) a statement of the time, place, and nature of public rule making proceedings;
>
> (2) reference to the legal authority under which the rule is proposed; and
>
> (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved. . . .
>
> (c) After notice required by this section, the Agency shall give interested persons an opportunity to participate in the rulemaking through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose . . . ."

Plaintiffs would have this Court believe that the Commission has somehow been remiss in failing to give timely and adequate notice of its rulemaking procedures. As we have seen, however, the Commission originally provided broad public notice of the general subject of its proposed rulemaking and, subsequently, gave notice of particular rules proposed to be adopted. In its release of October 22, 1975, 40 Fed. Reg. 49360, the Commission announced that it was considering the adoption of rules to regulate--or to ban--trading in commodity options,

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and provided an extensive description of the subjects, issues and alternatives involved in its consideration of that matter. Its later public release of February 20, 1976, 41 Fed. Reg. 7774, detailed the terms of specific rules that were proposed to be adopted, and an oral hearing was thereafter held on March 8, 1976, for the oral presentation of views of members of the public. Finally, after full consideration of all the issues that had previously been presented, and after full consideration of the carefully considered report of its Advisory Committee, the Commission, on October 8, 1976, announced final specific rule proposals, which, after further public comment, were later adopted substantially in the form proposed.

Throughout this rulemaking procedure, interested persons were repeatedly invited to, and did submit comments on all aspects and on specific issues.[79] In response, public participation was substantial. Quite apart from the public involvement in the deliberations of the Advisory Committee, the Commission received numerous letters of comment in response to the public notices it issued. In fact, notwithstanding plaintiffs' allegation (Amended Complaint, p. 2) that the Commission has denied plaintiffs and other interested persons an opportunity to submit comments, British American's counsel took an active role in the hearing held on March 8, 1976, and submitted comment letters on March 8,

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[79] Each notice contained the "agency's current attitudes" toward critical issues in addition to the Commission's position on all significant comments. See, Administrative Conference of the United States, Recommendation No. 76-3: "Procedures in Addition to Notice and Opportunity for Comment in Informal Rulemaking" (September 1, 1976). The Commission has in this rulemaking procedure complied with the suggested higher standards outlined in the recommendations of the Administrative Conference.

1976, addressed to the Advisory Committee, and on November 4, 1976, in response to the Commission's final request for comments. In its final adoption of regulations on November 24, 1976, as well as in prior releases, the Commission clearly indicated the consideration it had given to all relevant matters and incorporated a clear and complete statement of the basis and purpose of the rules; it specifically addressed, as well, every significant comment that had been received. In these circumstances, plaintiffs' suggestion that the Commission has failed to give adequate notice of its rulemaking and opportunity for public participation borders on the absurd.[80/]

To be sure, Section 4c(b) of the Commodity Exchange Act, as amended, 7 U.S.C. §6c(b) (Supp V, 1975), requires that the Commission exercise its pervasive rulemaking power only after the Commission has afforded notice and opportunity for hearing. But the procedures utilized by the Commission in adopting these rules meets this standard. In United States v. Florida East Coast Railway Co., 410 U.S. 224 (1973), the Court expressly held that a similar statutory requirement that the Interstate Commerce Commission adopt certain rules only "after hearing" imposed no greater obligation on the Interstate Commerce Commission other than to comply with the standards for notice and opportunity for written comment established under the Administrative Procedure Act. As we have seen, these standards have clearly been by this Commission. The Court held, 410 U.S. at 241, that a statutory

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80/ In Texaco Inc. v. Federal Power Commission, 412 F.2d 740 (3rd Cir. 1969) and National Labor Relations Board v. Wyman-Gordon Co., 394 U.S. 759 (1969), upon which plaintiffs rely (Memorandum, p. 2[illegible]), the Federal agencies involved had provided no notice whatsoever prior to exercising their rulemaking authority.

"hearing" requirement does

> ". . . not by its own force require the Commission either to hear oral testimony, to permit cross-examination of Commission witnesses, or to hear oral argument."

Similarly, in United States v. Allegheny-Ludlum Steel Corp., 406 U.S. 742, 758 (1972), the Court addressed the same statutory provision and upheld rules of the Interstate Commerce Commission, holding that the rulemaking

> ". . . proceeding . . . was governed by the provision of 5 U.S.C. §553 of the Administrative Procedure Act, requiring basically that notice of proposed rulemaking shall be published in the Federal Register, that after notice the agency give interested persons an opportunity to participate in the rulemaking through appropriate submissions, and that after consideration of the record so made the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. The 'Findings' and 'Conclusions' embodied in the Commission's report fully comply with these requirements, and nothing more was required by the Administrative Procedure Act."

That case is also dispositive of plaintiffs' further suggestion (Memorandum, p. 20) that this Court may and should consider whether the Commission's action is "unsupported by substantial evidence. . . ." The provision upon which plaintiffs rely, 5 U.S.C. §706(2)(E) (1970), expressly authorizes this standard of review only in "a case subject to Sections 556 and 557" of Title 5 of the United States Code--which prescribe a form of hearing that is normally appropriate only for adjudicative matters. In Allegheny-Ludlum Steel Corp., supra, 406 U.S. at 757, the Court explicitly held:

> "Sections 556 and 557 need be applied 'only where the agency statute, in addition to providing a hearing, prescribes explicitly that it "be on the record."' Siegel v. Atomic Energy Commission, 130 U.S. App. D.C. 307, 314, 400 F.2d 778, 785 (1968). . . ."

In that case, as in the case at bar, it was not enough to invoke those provisions that the statute merely referred to an opportunity for a hearing.[81/]

The Commission's compliance with the rulemaking provision of the Administrative Procedure Act also satisfies the requirements of constitutional due process. In California Citizens Band Association v. United States, 375 F.2d 43, 50 (9th Cir. 1967), for example, it was recognized that there is no

> ". . . constitutional requirement, under the Due Process Clause of the Fifth Amendment, or otherwise, for public evidentiary hearings in connection with such rulemaking. Bowles v. Willingham, 321 U.S. 503, 519. . . ."

Nor are the constitutional requirements of due process violated merely because the regulation that an agency adopts may impose a heavier burden on one party than another. In fact, many companies--and even whole

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[81/] Similarly, plaintiffs' contention (Amended Complaint, p. 4, 7, [illegible] and 10) that this Court should review these rules pursuant to 5 U.S.C. §706(2)(F), providing for limited trial de novo, has no legal foundation. Not only are the "facts" involved in the Commission determination "legislative" facts, not "adjudicative" facts, but the Act contains no provision for trial de novo. Cf., the Perishable Commodities Act, 7 U.S.C. §449(g) (1970).

industries--have been forced out of business by governmental regulation without there being any denial of due process. *See* *Bowles* v. *Willingham*, 321 U.S. 503 (1943); *Mulford* v. *Smith*, 307 U.S. 38 (1939). In upholding regulations of the Federal Price Control Administration, the Supreme Court stated in *Bowles* v. *Willingham*, *supra*, 321 U.S. at 518:

> "A member of the class which is regulated may suffer economic losses not shared by others. His property may lose utility and depreciate in value as a consequence of regulation. But that has never been a barrier to the exercise of the police power. . . ."

Similarly, the Commission is implementing a regulatory program pursuant to authority granted by Congress to regulate commodity option transactions. There will be no denial of due process even if plaintiffs should suffer some measurable economic loss as a result of that program. Thus, plaintiffs' contentions (Memorandum p. 16) that their due process rights are "being emasculated" has no merit. Their further contention (*id.*) that an entire industry may be eliminated, even if this were true, which plainly it is not. does not present a serious issue for judicial consideration, since the authority of the Commission to make this determination is beyond serious question, and the manner in which the Commission has proceeded has fully conformed with all statutory and judicially recognized rulemaking requirements.

Finally, plaintiffs allege (Amended Complaint, p. 3) that the Commission has violated that provision of the Administrative Procedure Act, 5 U.S.C. §553(d), which permits an agency to make substantive rules effective less than 30 days after the date of publication only for "good cause found and published with the rule." But the Commission's release of November 24, 1976, explained in full detail why it was necessary and appropriate that certain of the rules are to become effective only 15 days after their final publication and why, in light of prior notice and publication of the requirements, no person could reasonably claim to have been prejudiced by adoption of the shorter period. The Commission stated:

> In order to assure full and fair consideration of the various proposals that have been made over the many months in which option regulations have been considered, it has not been possible to implement appropriate regulations before now. That consideration having now been completed, however, the Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been fraught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof. 41 Fed. Reg. 51817 (November 24, 1976).

CONCLUSION

For the foregoing reasons, the Commission's Motion of Summary Judgment should be granted.

Respectfully submitted,

HOWARD SCHNEIDER
General Counsel

FREDERIC T. SPINDEL
PAT G. NICOLETTE
Associates General Counsel

FRED M. SANTO
GREGORY G. WALKER
JOAN L. LOIZEAUX
LOREN W. HERSHEY
Attorneys

Of Counsel

LESLIE A. BLAU
Special Counsel

Commodity Futures Trading
Commission
New York Regional Office
One World Trade Center
Suite 4747
New York, New York 10048

(212) 622-0784

Commodity Futures Trading
Commission
2033 "K" Street, N.W.
Washington, D.C. 20581

(202) 254-9880

December 3, 1976

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

ROBERT LA GRASSA, being duly sworn, deposes and says that deponent is not a party to the action, is over 18 years of age and resides at 62-20 60th Rd. MASPETH, NYC.

That on the 26th day of JANUARY, 19 77, deponent personally served the within JOINT APPENDIX (Volume I of II - Pages A-1 - A-416) upon the attorneys designated below who represent the indicated parties in this action and at the addresses below stated which are those that have been designated by said attorneys for that purpose.

~~By leaving _____ true copies of same with a duly authorized person at their designated office.~~

By depositing 1 true/copy ~~copies~~ of same enclosed in a postpaid properly addressed wrapper, in the post office or official depository under the exclusive care and custody of the United Stated post office department within the State of New York.

Names of attorneys served, together with the names of the clients represented and the attorneys' designated addresses.

HOWARD SCHNEIDER, ESQ.
General Counsel
Commodity Futures Trading Commission
Attorney for Defendants-Appellees
2033 K Street, N.W.
Washington, D. C. 20581

LEONARD GOLDSTEIN, ESQ.
Goldstein, Ahalt & Bennett
Counsel for other Plaintiffs-Appellants
4321 Hartwick Rd.
College Park, Maryland

Robert La Grassa

Sworn to before me this

26th day of JANUARY, 19 77.

Michael DeSantis

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Bronx County
Commission Expires March 30, 197[illegible] 77